SECTION 25137 PETITIONS AND PROCEDURES

A discussion of the process for the handling of issues under section 25137 of Revenue and Taxation Code, the standards for determining whether relief is appropriate and the type of relief that is appropriate.

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SECTION 25137 PETITIONS AND PROCEDURES

Contents **Page**

I. Introduction and Background.

A. The concept of distortion.

When the Supreme Court approved the "unit rule of assessment" in cases such as *Union Pacific Railway Co. v. City of Cheyenne*, 113 U. S. 516 (1885), *Western Union Telegraph v. Massachusetts*, 125 U. S. 530 (1888) and *Adams Express v. Ohio*, 165 U. S. 194 (1897), it sanctioned formula apportionment, that is, the use of some indirect measure to determine the proportion of the assets that could be included in the measure of tax by the taxing state. In so doing it created the need for a theory under which the courts could ensure that no state included in the measure of tax a share of assets out of all proportion to the assets actually used in the state.

In *Fargo v. Hart*, 193 U. S. 490 (1904), the Court refused to allow the value of out of state bonds and real estate that was not related to the business done in the taxing state to be apportioned to the taxing state. In *Union Tank Line Company v. Wright*, 249 U. S. 275 (1919), the Court disallowed the use of a mileage formula to apportion the value of tank cars to Georgia where on average there were 57 such cars in the state each day, while according to the mileage formula there was an average of 357 cars in the state each day (a difference of 526 percent). The Court said that because absolute accuracy is impossible in such situations it had "…sustained methods of appraisement that are approximately correct… But if the plan pursued is arbitrary and the consequent valuation grossly excessive it must be condemned because of conflict with the Commerce Clause and the Fourteenth Amendment or both."

In *Wallace v. Hines*, 253 U. S. 66 (1920), the Court struck down a North Dakota assessment on the property of a railroad where the property subject to apportionment by a mileage formula included stocks and bonds owned out of state by the taxpayer that did not add to the value of the roads or rights exercised in North Dakota. The court also disapproved the use of the mileage formula in the case because the value of a mile of North Dakota track was considerably less than the value of a mile of track in a more densely populated region and the mileage formula did not properly reflect or allocate the value of the large terminals that were located in other states.

In the same year that it decided *Wallace v. Hines*, the Court decided *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113 (1920), in which it approved interstate apportionment for income tax purposes. In so doing it relied on *Western Union Telegraph Co v. Massachusetts*, *supra*, *Adams Express v. Ohio*,

supra, and similar cases involving railway, telegraph and express company operations. In rejecting the argument of the taxpayer that formula apportionment based on the ratio of the value of in-state tangible property to all such property wherever located resulted in the apportionment to Connecticut of income earned outside the state, the Court said that the taxpayer had the burden of showing that 47 percent of its income was not derived from the manufacturing of typewriters in Connecticut the sale of which in other states accounted for 80 percent of its income. Because the taxpayer had not attempted to make such a showing the Court said that there was nothing in the record "…to show that the method of apportionment adopted by the State was inherently arbitrary or that its application to this corporation produced an unreasonable result." This signaled that the analysis used in dealing with alleged distortion in apportioning values for property tax purposes would also apply in the income tax context.

1. Fairly reflective of how the business is done.

Eleven years later in *Hans Rees' Sons Inc. v. North Carolina*, 283 U. S. 123 (1931), the Court resolved the first and only case in which it determined that an otherwise constitutional formula for apportioning income could operate in a distortive and unconstitutional manner. North Carolina used an apportionment formula identical to that approved by the Court in *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113, *supra.* However in *Hans Rees*, because the tangible property that was used in the apportionment formula was disproportionately located in North Carolina the formula caused income to be over-apportioned to that state and under-apportioned to New York where the taxpayer had a sales operation. In analyzing the constitutionality of the formula used by North Carolina the Court used language similar to that used in *Union Tank Line Company v. Wright*, 249 U. S. 275, *supra*, saying, "The difficulty of making an exact apportionment (in the case of a unitary business) is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases."[1]

The court concluded with the statement that the apportionment formula attributed to North Carolina "…a percentage of income out of all appropriate proportion to the business transacted by appellant in that state."

[1] That the analysis of the distortion issue in the income tax context was influenced by the analysis that had long been used in cases dealing with allegations of distortion in the apportionment of the property of railroads, express companies, etc., was made clear by the Court in *Container Corporation of America v. Franchise Tax Board*, 463 U. S. 159 (1983), when, in the same sentence, the Court cited *Hans Rees' Sons* for the proposition that an apportionment formula would be struck down if the taxpayer could show by clear and cogent evidence that the formula attributed income to a state out of all appropriate proportion to the business done in the state, and *Norfolk and Western Railway Co. v. Missouri Tax Commission*, 390 U. S. 317 (1968), for the proposition that the formula would be struck down if it led to a grossly distorted result. *Norfolk and Western* dealt with the apportionment of railway rolling stock for property tax purposes.

2. Internal consistency, external consistency and discrimination.

In *Container Corporation of America v. Franchise Tax Board*, 463 U. S. 159 (1983), the Supreme Court articulated the requirements for an acceptable apportionment formula and conversely what must be shown to demonstrate that an apportionment formula is distortive. First, the formula must pass the internal consistency test; it must operate so that if it were used by every state, no more than 100 percent of the income of the taxpayer would be apportioned to the states. Second, the formula must pass the external consistency test; the factors in the formula must actually reflect "a reasonable sense of how income is generated." This means that there must be a rational relationship between the taxpayer's business activity in the state and the factors in the formula so that it reflects the activities that generate the taxpayer's income in the state. Third, the formula must not discriminate against interstate or foreign commerce, either facially or in its effect. In *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U. S. 71 (1992), the Court made it clear that in the foreign commerce context an apportionment scheme need not favor the commerce of the taxing state to discriminate impermissibly against foreign commerce. The court said "…a state's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause even if the state's own economy is not a direct beneficiary of the discrimination. As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions." (*Id*. 79.)

The test for determining whether a formula impermissibly discriminates against foreign commerce starts with the test for determining whether a formula discriminates against interstate commerce and adds to it, two additional components related to the need for the United States to speak with one voice in the area of foreign affairs and to the increased risk of multiple taxation in the international sphere. In analyzing the acceptability of a formula under the Foreign Commerce Clause, the Court uses the same tools that it uses under the Due Process and Interstate Commerce Clauses. In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U. S. 425, 447 (1980), the Court said:

> "A discriminatory effect on foreign commerce as a result of multiple taxation, is just as detectable and corrigible as a similar effect on commerce among the states. Accordingly, we see no reason why the standard for identifying impermissible discrimination should differ in the two instances."

In *Container*, *supra*, the Court made it clear that the "substantial margin of error" test applied in the interstate commerce context also applies in the foreign commerce context to determine the fairness of an apportionment

formula; that is, the formula will stand unless it apportions an amount of income to the taxing state that is "…out of all appropriate proportion to the business transacted in that State." (463 U. S. at 181.)

In *Barclays Bank PLC v. Franchise Tax Board*, 512 U. S. 298, 312 (1994), the Court again made it clear that the test for discrimination in the foreign commerce context is the same as the test in the interstate commerce context by applying the identical test, saying that the taxpayer had not demonstrated a "…lack of a rational relationship between the income attributed to the State and the intrastate values of the enterprise."

In order to show distortion under the Constitution the taxpayer must show either that the formula will result in double taxation, by subjecting more than 100 percent of the income of the taxpayer to taxation, or that the formula does not reflect how the business actually operates. The taxpayer must then show that a better method exists and it must show, by the use of its better method, that the results of the standard method are outside the bounds of the "rough approximation" permitted by the Constitution.

The only circumstance in which this three part analysis does not apply is when the taxing scheme in which the formula operates or the formula itself is facially discriminatory against interstate or foreign commerce. Thus, in *Kraft General Foods, Inc.*, *supra*, where the taxing scheme facially discriminated against foreign source dividends, the Court did not examine the results of the scheme to determine whether it apportioned a disproportionate amount of the taxpayer's income to Iowa.

B. The need for Uniform Division of Income for Tax Purposes Act, section18 and Revenue andTaxation Code section 25137.

1. Constitutional safety valve.

Prior to the promulgation and adoption of the Uniform Division of Income for Tax Purposes Act (hereafter UDITPA) a statute like section 18 of the act was not needed in California (or in many other states) because, under the pre-UDITPA apportionment statute the Franchise Tax Board, like revenue agencies in other states, was given wide discretion to select, for each taxpayer, the apportionment formula that best reflected the way in which the taxpayer carried out its business operations. (*Household Finance Corp. v. Franchise Tax Board*, 230 Cal. App.2d 926 (1964), *Amoco Production Co. v. Armold, Director of Taxation*, 213 Kan. 636 (1974), *Donald M. Drake Co. v. Department of Revenue*, 263 Or. 26 (1972), *Kennecott Copper Corp. v. State Tax Commission*, 27 Ut.2d 119 (1972).)

Because one of the goals of UDITPA is uniformity among the states it prescribed a uniform three-factor formula based on payroll, tangible property

and sales, identical to the formula approved by the Supreme Court in *Butler Brothers v. McColgan*, 315 U. S. 501 (1942). Because the statute now prescribed a standard formula which, although constitutional in its usual application, might be unconstitutional as applied in a specific case, it was necessary to have a statutory safety valve to enable revenue agencies to avoid constitutional problems.

Section 18 of UDITPA and section 25137 of the Revenue and Taxation Code provide that when the allocation or apportionment provisions of the act do not "…fairly represent the extent of the taxpayer's business activity in… the state, the taxpayer may petition for or the Franchise Tax Board may require…" an alternative formula or separate accounting.

2. Fair distribution of tax revenues and burdens.

In his 1957 article explaining UDITPA, (The Uniform Division of Income for State Tax Purposes Act, Taxes, Tax Magazine, October 1957, Vol. 35, No. 10) William J. Pierce, the principal draftsperson of the act, explained the purpose behind section 18. He said that the section was intended to be used when the standard formula reached "…arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds." He also said that: "…departures from the basic formula should be avoided except where reasonableness requires." He then went on to say that "Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics." The "as well as" clause clearly implies that section 18 could be used even if the standard formula did not result in actionable distortion under the Constitution. If the act can apply in "unusual cases" as well as those in which the standard formula will reach an unconstitutional result, then by the terms of the statute both the taxpayer and the Franchise Tax Board have the right to seek the application of the statute in the appropriate case.

In *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., February 3, 1977, the Board of Equalization emphasized the goal of UDITPA set forth in Revenue and Taxation Code section 25138 to "…make uniform the laws of those states which enact it…" and said "In order to insure that the Act is applied as uniformly as possible, we hold that the party who seeks to deviate from the statutory formula, whether the taxpayer or the taxing agency, will bear the burden of proving that such exceptional circumstances are present." The Board sustained the action of the Franchise Tax Board in assigning the wages of New York based football players to California for payroll factor purposes when one of their games was played in this state.

As authority for the proposition that 25137 should be narrowly construed but that it could be invoked by the tax agency when the standard formula reached an unreasonable but not unconstitutional result, the Board relied on the article by Frank Keesling and John Warren, California's Uniform Division of Income for State Tax Purposes Act, 15 UCLA L. Rev. 156, and on decisions by the Supreme Courts of Kansas and Oregon, including *Donald M. Drake Company v. Department of Revenue*, 263 Ore. 26 (1972), which also relied on the Keesling and Warren article. In the Kansas case, *Amoco Production Co. v. Armold*, 213 Kan. 636, *supra*, the court relied on *Kennecott Copper Company v. State Tax Commission*, 27 Ut.2d 119, *supra*, for the proposition that under section18 the revenue agency had the authority to depart from the standard formula when that formula did not fairly represent the extent of the taxpayer's activity in the state. It is now accepted in California and generally in the UDITPA states that the relief provisions of UDITPA section 18 may be invoked by the taxing state when the standard formula results in the under representation of the business of the taxpayer in the state.[2] (See for example, *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978.)

C. Principles guiding the application of section 25137.

1. The section only applies to UDITPA provisions of the Revenue and Taxation Code.

   Revenue and Taxation Code section 25137 provides for the use of alternative apportionment methodologies "…if the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state." Section 25139 says that sections 25120 through 25139 "…may be cited as the Uniform Division of Income for State Tax Purposes Act." Thus the reference to the "apportionment provisions of this act" in 23137 means that 25137 cannot be invoked to correct inequities caused by other provisions of the Code, that are not part of UDITPA. In *Appeal of CTI Holdings, Inc*, 96-SBE-003, February 22, 1996, the Board of Equalization first rejected the taxpayer's argument that foreign taxes paid on dividends that were eliminated from the combined report by Revenue and Taxation Code section 25106 could not be taxes measured by income because the elimination of the dividends by 25106 also stripped them of their income characteristics. The taxpayer then argued in the alternative that denying it the right to deduct the foreign taxes from its income subject to apportionment resulted in distortion. The Board also rejected this argument saying; " Section 25137 is part of UDITPA, which is codified in Revenue and

[2] Subsequent to the decision in *Donald M. Drake Company*, *supra*, the Oregon legislature amended the Oregon statute so that it only applied to cases in which the standard formula produced results that violated the constitutional rights of the taxpayer. Still later the legislature realized that the original formulation had been correct and again conferred on the Department of Revenue the authority to invoke the statute on behalf of the state.

Taxation Code sections 25120 through 25139. However, UDITPA only deals with the allocation and apportionment of income, not with the determination of what constitutes income."

2. The analytical framework.

   a. Reflective of how business is done.

      On February 3, 1977, the Board of Equalization decided the first four appeals in which it was asked to apply section 25137. In two of them it sustained the action of the FTB in modifying the standard formula because the standard formula did not accurately reflect the California business of the taxpayer. In *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., *supra*, section 25133 would have assigned the entire payroll of the taxpayer to New York despite the fact that it played a game and earned income in California. In that case the Board sustained the action of the FTB in assigning payroll costs to California to reflect a game played here and said: "Computing appellant's payroll factor in the manner prescribed in the Uniform Act would assign its entire payroll to New York. This would not reflect the fact that appellant's team plays a number of games outside New York, including occasional games in California." In other words, the standard formula did not fairly reflect the way in which the taxpayer did its business in California.

      In *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., Feb. 3, 1977, the Board sustained the action of the Franchise Tax Board in applying a special apportionment process to income received by the taxpayer at the end of a construction project and accounted for under the completed contract method of accounting authorized by Treasury Regulation section 1.451-3. The standard apportionment procedure would have apportioned the entire income from a multi-year construction project using the factors of the year in which payment was received. Because these factors would not have been reflective of how the business of the taxpayer was carried out during the years in which the project was being built the Board sustained the Franchise Tax Board's use of the prior year factors to apportion the income. In *Tenneco West, Inc. v. Franchise Tax Board*, 234 Cal. App.3d 1510 (1991), the Court endorsed the decision in *Appeal of Donald M. Drake, supra,* and Legal Ruling 413 on which it was based. The court said "…apportioning installment sale income here on the basis of the factors in the year the income was received would result in apportionment of income by activities having no connection to the earning of the income. Apportionment based on the factors of the year of sale more closely reflects the activities which gave rise to the income."

      In a similar vain, the decision in *Appeal of Milwaukee Professional Sports and Services, Inc.* (the Milwaukee Bucks), Cal. St. Bd. of Equal., June 28

1979, endorsed the position of the Franchise Tax Board that the application of section 25137 was appropriate when the standard apportionment formula would apportion no income to California despite appellant's "substantial" business in the state consisting of approximately 10 percent of the basketball games that it played over a three year period.

When the standard formula is not so clear cut in its distortive effect the courts and the Board of Equalization look at the degree to which the standard factors fail to reflect the income producing factors of the business, the nature of the effect of that failure and the degree to which the apportionment results of the defective standard formula differ from the results achieved by a "better" formula to determine whether section 25137 should be applied. The Board of Equalization made this clear in *Appeal of American Telephone and Telegraph Company*, Cal. St. Bd. of Equal., June 29 1982, when it first pointed out the goal of UDITPA to ensure that 100 percent of the income of a taxpayer was subject to tax and then said:

> "Our holding in this case is not inconsistent with our decision on rehearing in the New York Football Giants appeal, where we refused to allow respondent to make a sales factor adjustment of greater magnitude than the adjustment it seeks in this case. (*Appeal of New York Football Giants, Inc*., Op. on Rehg., June 28, 1979.) That appeal did not involve a situation where some of the taxpayer's income would escape all state taxation if the normal apportionment provisions were applied. The instant case does involve that problem, and the criteria by which respondent's authority under section 25137 is to be measured are not necessarily the same in both situations. For example, when the possibility of duplicative taxation exists, as it often will when the various taxing states apply different apportionment formulas to the same taxpayer, it seems entirely appropriate to strictly limit the use of section 25137. But duplicative taxation is not a possibility in this case, and it therefore seems equally appropriate to allow respondent somewhat greater latitude under section 25137, is order to ensure that the basic purposes of UDITPA are carried out."

Four years earlier, in *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978, the Board had sustained the action of the Franchise Tax Board in applying section 25137 to eliminate from the sales factor the gross receipts from the treasury function that accounted for approximately one third of the nationwide receipts of the entire Bell system. Without discussing the effect on the California apportionment percentage the Board said that the application of 25137 was appropriate because the treasury function gross receipts by

themselves would have caused 11 percent of the income of the Bell System to be apportioned to New York.[3] In support of its decision the Board discussed the theoretical basis for the sales factor as reflecting the market for the goods or services offered by the taxpayer. It then said "Where, as here, we are asked to decide whether certain receipts belong in the factor, we believe that the relevant inquiry is whether including those receipts would tend to accomplish the sales factor's basic function."

b. Degree of distortion.

In the earliest cases in which relief was granted under section 25137 the Board did not conduct an analysis to determine whether the income attributed to the state by the standard formula was out of all appropriate proportion to the business done in the state by the taxpayer. (See for example *Appeal of New York Football Giants, Inc*., *supra*, and *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., *supra*.) *Appeals of Pacific Telephone and Telegraph Company,* Cal. St. Bd. of Equal., *supra*, was the first decision in which the Board analyzed both the fact of distortion, that is the failure of the standard formula to adequately represent the business done in California by the taxpayer, and the degree of the asserted distortion, to determine whether relief was appropriate under section 25137. In the context of that case it found that what amounted to an 11 percent variance in the California apportionment percentage justified the application of section 25137.

In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith*, Inc., 89-SBE-017, June 2, 1989, the Franchise Tax Board argued that it was distortive to include the gross receipts from the taxpayer's New York underwriting activities in the sales factor. The Board of Equalization rejected the FTB argument. The Board first distinguished *Merrill, Lynch* from *Appeals of Pacific Telephone and Telegraph* Company, *supra*, where the distortive treasury function had been tangential to the main business of the taxpayer saying: "In contrast, we are not dealing here with an incidental part of the appellant's unitary business, but with a fundamental segment of the financial services provided by appellant. More importantly, however, the FTB has made no showing of distortion such as was made in *Pacific Telephone*." The Board then went on to articulate what has come to be known as the *Merrill, Lynch* standard. It cited *Container Corporation of America*, *supra*, and other cases for the proposition that a rough approximation is all that is required so long as the formula itself fairly reflects the business activity of the taxpayer in California. It then said that

[3] Since the apportionment of 11 percent of the income to New York would have reduced the income apportionable to the rest of the states by 11 percent, the amount apportioned to each state, including California would have been reduced by11 percent. Thus, when the activity generating the income is an incidental function, section 25137 can be invoked when the distortive effect of the standard formula is as little as 11 percent.

a difference of between 23 and 36 percent was a far cry from the difference of 250 percent that led the Supreme Court to strike down the apportionment formula in *Hans Rees' Sons, Inc*. and that the a difference of as much as 36 percent was within the substantial margin of error inherent in any apportionment method.

3. Distortion of constitutional significance.

When an apportionment formula does not fairly reflect how income is generated (*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, *supra*.) it will be struck down under the U. S. Constitution if it apportions to the taxing state a percentage of the taxpayer's income that is "out of all appropriate proportion" to the business transacted in that state by the taxpayer. (*Hans Rees' Sons v. North Carolina*, 283 U. S. 123, *supra*.) Because the constitution only comes into play in the apportionment context when a state over-apportions income to itself, the constitutional standard for what constitutes impermissible distortion only applies in cases of asserted over-apportionment and the resulting double taxation. Therefore, there is no constitutional standard for what constitutes actionable distortion where the standard formula creates nowhere income or for the distortion that exists when a corporation does business in a state and the standard formula does not apportion any income to that state.

In the context of income apportionment the Supreme Court has only found distortion requiring action under the Constitution in a single case. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U. S. 123 (1931), involved over-apportionment and thus potential double taxation. In that case the single factor formula used by the state apportioned 80 percent of the taxpayer's income to North Carolina while the formula proffered by the taxpayer would have apportioned 21.7 percent of its income to the state, a difference as the Court observed in *Container Corporation of America v. Franchise Tax Board*, 463 U. S. 159, *supra*, of in excess of 250 percent. Because the single factor formula did not reflect the way in which the business earned its income and because a 250 percent deviation in the apportionment percentage was out of all appropriate proportion to the business done in the state by the taxpayer its use was struck down by the Court.

In *Moorman Manufacturing Company v. Bair*, 437 U. S. 267 (1978), the Court sustained the use of a single factor apportionment formula based on sales where that formula apportioned 48 percent more income to the taxing state than would have been apportioned using the type of three factor formula approved in *Butler Brothers v. McColgan*, 315 U. S. 501, *supra.*

In *Exxon Corporation v. Department of Revenue*, 447 U. S. 207 (1980), the Court approved the use of formula apportionment by the state of Wisconsin saying that "…a state may apply an apportionment formula to the taxpayer's

total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.' "

Three years later in *Container Corporation of America v. Franchise Tax Board,* 463 U. S. 159, *supra*, the Court said that separate accounting had theoretical weaknesses that justify the use of formula apportionment, that the inherent margin of error in the three factor formula was no greater than that in separate accounting, and that a difference of 14 percent was "…within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."[4]

In *Colgate-Palmolive Company, Inc. v. Franchise Tax Board*, 10 Cal.App.4th 1768 (1992), affd. 512 U. S. 298 (1994) the court of appeal provided some further guidance on what constitutes a degree of distortion requiring action under the constitution. The taxpayer argued that the standard apportionment formula over-apportioned to California by 70 percent. The Court said that Colgate's figure of 70 percent "...is not comparable to the 250percent tally in *Hans Rees*. Colgate has not met the steep burden imposed by the constitutional distortion principle of external consistency."

4. Distortion of statutory significance: Numbers and concepts.

In *Colgate-Palmolive Company, Inc. v. Franchise Tax Board*, 10 Cal.App.4th 1768, *supra*, the court noted that the test under the constitution for determining whether the asserted distortion requires action differs from the test under section 25137. Under the constitution the test is whether the income apportioned to the state is "out of all appropriate proportion" to the business done in the state, while under section 25137 the test is whether given the flows of value in a unitary business the formula unfairly represents the business activities of the taxpayer in the state. This raises the question whether the numerical standards are also different.

It is often said that *Appeal Merrill, Lynch, Pierce, Fenner & Smith, supra,*[5] sets the numerical standard for what constitutes actionable distortion under

[4] While separate accounting cannot by itself impeach the results of formula apportionment, it appears that separate counting can. In *Norfolk & Western Railway Co. v. North* Carolina, 390 U. S. 1046 (1968), the court struck down the use of a mileage formula to apportion rolling stock to Missouri for property purposes. By actual count of rolling stock in the State on tax day, the railroad showed that 2.71 percent of its rolling stock was in the state. This was good enough to impeach the apportionment formula which assigned 8.28 percent of the rolling stock to the state.

[5] *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. 89-SBE-017, *supra*, also enunciated the rule that the entire apportionment formula and not just a single factor must be analyzed when there is a claim of distortion. The basis for the statement is the observation that the distortion cause by one factor in one direction may be offset by the distortive effect of one of the other factors in the other direction. As the cases demonstrate, this is a rule often honored in the breech due to the fact that the parties are usually in

section 25137, but as the discussion above shows, there are five different circumstances, with different thresholds for the application of 25137.

- When a corporation does business in California but the standard apportionment formula will not apportion any income to California, it does not appear to be necessary to engage in the type of comparative numerical analysis carried out in *Merrill, Lynch* and *Hans Rees' Sons.* (See *Appeal of Milwaukee Professional Sports and Services, Inc.* (the Milwaukee Bucks), Cal. St. Bd. of Equal., *supra*.)

- When the factors in the standard formula are unrelated to the way in which income is generated or to the time during which the income is generated it may not be necessary to engage in the type of comparative numerical analysis carried out in *Merrill, Lynch* and *Hans Rees' Sons.* (See *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., *supra*, and *Tenneco West, Inc. v. Franchise Tax Board*, 234 Cal. App.3d 1510 (1991). Also, see *Appeal of Fluor Corporation*, 95-SBE-009, August 31, 1995, in which the Board discussed the opinion of the Oregon Supreme Court in *Crocker Equipment Leasing v. Department of Revenue*, 314 Ore. 122 (1992), in an approving manner.)

- When the standard apportionment formula will result in the creation of "nowhere" income in conflict with the basic goal of UDITPA that 100 percent of the income of the taxpayer should be subject to tax, the analysis in *Appeal of American Telephone and Telegraph Company,* Cal. St. Bd. of Equal., *supra*, applies and the threshold for the application of section 25137 can be below 40 percent.

- When the factors in the formula, while reflective of the business activity of the taxpayer, do not "fairly" or accurately reflect that activity, thus subjecting the taxpayer to the risk of double taxation or resulting in under-apportionment to California, the *Merrill, Lynch* analysis applies and the threshold for action under 25137 is relatively high. (See also *Colgate-Palmolive Company, Inc. v. Franchise Tax Board*, 10 Cal. App.4th 1768, *supra*, in which the court, while dismissing the taxpayer's claim that the standard formula resulted in 70 percent over-apportionment to California said that 70 percent was not comparable to the "250 percent tally in *Hans Rees*" thus implying that 70 percent is an acceptable degree of distortion in this circumstance.[6])

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dispute about one of the factors and the "better method" against which the results of the standard formula is being measured is a global method rather than a factor specific method.

[6] For a contrary approach see *Unisys Corporation v. Commonwealth*, 726 A.2d 1076 (Pa. 1999), in which the court determined that the standard for granting relief under the equitable relief statute was different

- When one or more of the factors is skewed or distorted by a substantial amount of activity that is not related to the main line of the business of the taxpayer, the analysis in *Appeal of Pacific Telephone and Telegraph Company* Cal. St. Bd. of Equal., *supra,* applies and the threshold for the application of 25137 can be as low as 11 percent.

Prior to UDITPA the tax administrator was typically endowed with discretion to select an apportionment formula in each case that best represented the business operations of the taxpayer. Thus, if the taxpayer or the Franchise Tax Board could devise a more representative formula in a given case, the Franchise Tax Board was free to adopt it. UDITPA deprived tax administrators of this discretion. In *Appeal of New York Football Giants, Inc*. Cal. St. Bd. of Equal., *supra*, in its petition for rehearing the Franchise Tax Board argued that it should be allowed to use a special formula that more accurately apportioned the income of the taxpayer. The Board acknowledged the superiority of the special formula, but rejected its application because it had not been shown that the standard formula did not fairly represent the business of the taxpayer.

Again in *Appeal of Merrill, Lynch, supra*, the Board said:

> "The FTB has also attempted to justify application of section 25137 by contending that its method is 'better' than the standard formula. We have consistently rejected this type of argument as unavailing; what must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected. (See, e.g., *Appeal of New York Football Giants,* Inc., Opn. on Pet. Rhg., *supra*.)"

(Also see *Appeal of Retail Marketing Services*, Inc. 91-SBE-003, August 1, 1991.)

D. Impact of regulations, legal rulings, etc.

1. Title 18, California Code of Regulations, section 25137-1 through 25137-12 (18 CCR 25137-1 through -12).

   California and most other UDITPA states have adopted special regulations dealing with circumstances and industries for which the standard apportionment formula would not provide a fair apportionment. These special

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and lower than the standard used in the "out of all appropriate proportion" test under the constitution. In that case the court found that a disparity of 44.5 percent was not sufficient to result in a constitutional violation, but that it was sufficient to trigger the need for relief under the equitable relief statute.

regulations are found at Title18, California Code of Regulations,[7] sections 25137-1 through -12.

- 25137-1 prescribes the rules to be used to apportion a corporation's distributive share of partnership items when a multistate corporation has an interest in a partnership.

- 25137-2 prescribes the rules to be used to apportion the income of a multistate construction contractor when the contractor receives income under a long term construction contract to which the accounting methods provided by Internal Revenue Code section 460 or Treasury Regulation section 1.451-3 have been applied.

- 25137-3 prescribes the rules to be used to apportion the income of a multistate corporation derived from the business of franchising.

- 25137-4.2 prescribes the rules to be used to apportion the income of banks and financial corporations where intangible property is a major factor in the generation of income.

- 25137-5 sets forth the rules to be used to apportion the income of multistate commercial fishing operations.

- 25137-7 prescribes the rules for apportioning the income of multistate air transportation companies (airlines).

- 25137-8 prescribes the rules for apportioning the income of multistate television networks and film producers.

- 25137-9 prescribes the rules for apportioning the income of multistate railroads.

- 25137-10 prescribes the rules for apportioning the income of multistate entities that combine the operations of a financial corporation with those of a general corporation.

- 25137-11 prescribes the rules for apportioning the income of interstate trucking companies.

- 25137-12 prescribes the rules for apportioning the income of multistate producers of periodical print media such as magazines, newspapers, trade periodicals etc.

[7] Hereafter, unless otherwise indicated Title 18 of the California Code of Regulations will be referred to as "18 CCR."

2. The weight to be accorded to the regulations.

   Given the UDITPA goal of uniformity the question arises as to what degree of deference should be accorded to special apportionment regulations adopted by the Franchise Tax Board. The Board of Equalization first confronted this issue in 1984 in *Appeal of Union Carbide Corporation,* Cal. St. Bd. of Equal., April 5, 1984 in which the taxpayer sought to take advantage of a special regulation under section 25137. The Board did not address the validity of the regulation saying instead that the existence of the regulation, which applied to the agreed facts of the case, proved that the Franchise Tax Board and the taxpayer both agreed that exceptional circumstances were present that justified the application of section 25137. Two short months later in *Appeal of Triangle Publication, Inc.*, Cal. St. Bd. of Equal., Aug 1, 1984, the Board of Equalization said the Franchise Tax Board could not invoke the special regulations under section 25137 unless it first demonstrated that the standard formula did not fairly reflect the extent of the taxpayer's business in the state and that it could not use its own regulation to meet the burden of proof under section 25137. (Also see the unpublished opinion in *Appeal of Pneumo Abex Corporation*, Cal. St. Bd. of Equal., April 7, 1994, relying on *Appeal of Triangle Publication, Inc.)* Finally, in *Appeal of Fluor Corporation*, 95-SBE-016, Dec 12, 1995, the Board confronted the fact that its previous decisions had been confusing and had created a situation in which taxpayers could whipsaw the state. It then surveyed decisions in other UDITPA states and held that the special formulas provided in the regulation must be applied whenever the facts and circumstances of a particular case match those set forth in one of the special regulations, unless one of the parties demonstrates that the special formula does not fairly represent the extent of the taxpayer's business activities in the state.

3. Other "special rules."

   In addition to the regulations adopted under Revenue and Taxation Code section 25137 there are special rules in regulations adopted under other sections of the Code that amount to special rules of apportionment.

   a. Revenue and Taxation Code section 25135 provides the rules for determining the state to which the sale of tangible personal property will be assigned for sales factor purposes. Subdivision (a)(2) of the statute provides that when the seller is not taxable in the state to which the property is delivered, the sale will be assigned to the state from which the property was shipped. At 18 CCR 25135(a)(7) the regulation provides that where the seller is not taxable in the state of sale or in the state from which the property is shipped, and where the sales person who made the sale operates from an office in California, the sale will be assigned to California. (Without such a provision the sale would not be assigned to any state.)

b. Revenue and Taxation Code section 25136 provides the rule for determining the state to which the sale of an intangible will be assigned. The statute assigns the sale to the state in which the greater proportion of the income producing activity occurs. However, at 18 CCR 25136(d)(2)(A) the regulation provides that receipts from the rental of realty are assigned to the state where the property is located. At 25136(d)(2)(B) it provides that receipts from the rental, lease or licensing of tangible personal property are separate items of income as to each state in which the items are used and that the income from such rental, lease or licensing is assigned to the state in which the property is used proportionate to the percentage of time the property is used in each state. At 25136(d)(2)(C) the regulation provides that receipts for personal services are assigned to the state in which the services are performed and that when services are performed in two or more states, the service in each state is considered to be a separate income producing activity and that receipts will be assigned in a manner proportionate to the amount of time spent performing the service in each state. These results differ from what would be expected under the bare language of the statute**.**

c. In 1964 the Franchise Tax Board issued Legal Ruling 267, which, in dealing with a retail seller, said that proceeds from installment sales should be apportioned using the factors of the year in which the receipts were received rather than the factors of the year in which the sale was made. In 1979 the Board issued Legal Ruling 413, which dealt with a taxpayer that sold a substantial portion of its business assets. In drafting Legal Ruling 413, the Franchise Tax Board was guided by the 1977 decision of the Board of Equalization in *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., *supra*, in which the Board said that income accounted for under the completed contract method of accounting should be apportioned using the factors of the years during which the income was earned rather than those of the year in which it was received. Based on the holding in *Drake,* Legal Ruling 413 took the position that the proceeds of installment sales should be apportioned using the factors of the year in which the sale was made rather than those of the year in which the income was received. In *Tenneco West, Inc. v. Franchise Tax Board*, 234 Cal App 3d 1510 (1991), the court endorsed the Legal Ruling and held that it did not only apply when a taxpayer sold a substantial portion of its business assets. The court pointed out that Legal Ruling 413 contained an exception for retail sellers of tangible personal property of the type dealt with in Legal Ruling 267 and that as a result the two rulings were not in conflict. (See also, *Appeal of PDA Engineering 95- SBE-014,* November 28, 1995.) In 1998, Legal Ruling 267 was withdrawn. However, because Legal Ruling 413 contains an exception for retail sellers of the type covered by former Legal Ruling 267, the withdrawal of Legal Ruling 267 is without effect.

4. Other administrative guidance.

   The Multistate Audit Technique Manual (MATM) provides guidance to Franchise Tax Board auditors. The Manual provides guidance on applying all of the special statutory and regulatory apportionment rules and in addition provides guidance to be used in industries not covered by the regulations where the standard formula will often result in distortion.

   There are a total of 25 industry or situationally specific MATM sections. Twelve of them simply explain the effect of the regulations that have been adopted pursuant to Revenue and Taxation Code section 25137. Two of them, Professional Sports and Timber, are based on other statutory authority that applies equally to taxpayers and to the Franchise Tax Board. Four of them, Mining, Printers, Oil & Gas, and Offshore Drilling Contractors, do not actually set forth an alternative apportionment formula, but instead explain the operations of the industry and how those operations effect what goes into the standard apportionment formula. Two of them, Stockbrokers and Telecommunications Companies, are based on and cite to controlling SBE decisions dealing with the industry. That leaves five MATM sections under which an alternative apportionment formula would be used where the formula is not mandated by a statute, regulation or controlling case. These five are Sea Transportation Activities, Bus Transportation, Freight Forwarding Companies, Pipeline Companies and Vessels Such as Tugboats, Barges, Etc.

   The existence of the MATM sections raises two questions.

   - Do they constitute underground regulations?

   - Do they bind the Franchise Tax Board even though they are not binding on taxpayers?

   In *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., *supra*, the Board of Equalization said relative to a regulation under Revenue and Taxation Code section 25137:

   > "Although we have consistently held that the party requesting use of a special formula bears the burden of showing that exceptional circumstances exist, that requirement seems an empty exercise when the parties agree that exceptional circumstances exist. Appellant has stated that exceptional circumstances exist because it was impossible for it to own or rent the facilities and because of the nature of its use of the facilities, which entailed essentially all the attributes of ownership or rental except for title or a lease. Respondent, by its specific regulation on the subject pursuant to section 25137, must be

considered to have implicitly agreed that this circumstance is exceptional and requires a special formula."

In *Appeal of Triangle Publications, Inc*., Cal. St. Bd. of Equal., *supra*, the Board of Equalization said that the Franchise Tax Board could not rely on its regulations under Revenue and Taxation Code section 25137 to establish that the standard formula did not fairly represent the business of the taxpayer in California. Thus, taxpayers could use the regulations to carry their burden of proof relative to the inappropriateness of the standard formula, but the Franchise Tax Board could not. Whether the MATM sections create the same situation has not been tested in a petition, appeal or court case but as to the majority, it is not likely that they do.

Those MATM sections that simply explain the effect of the 25137 regulations or other statutes or regulations (*i.e.* Professional Sports or Oil & Gas.) take with them the authority of those statues and regulations that are equally binding on the taxpayer and on the Franchise Tax Board. Those that are based on and explain the application of precedent-setting court and Board of Equalization decisions (*i.e.* Telecommunications.) simply explain how those decisions would apply to similar facts, and it is the underlying decision and not the MATM section that establishes the distortive nature of the standard formula as applied to those facts. Those that simply explain how particular industries operate and point out the effect of those operations on the characterization of the goods and services that they provide (*i.e.* Printing.) merely provide information and do not mandate or permit any action. This leaves five MATM sections under which an alternative formula would be used, where there is not statutory, regulatory or case authority for the imposition of a revised formula.[8] Relative to these five sections, it is possible, in the event of a disagreement between the taxpayer and the Franchise Tax Board, that the Franchise Tax Board will be in the position that it was in relative to regulations before the decision in *Appeal of Fluor Corporation,* 95-SBE-016, *supra*. That is, in order to apply one of the five sections in the face of taxpayer opposition, the FTB will be required to demonstrate that the standard formula does not fairly reflect the business of the taxpayer in California and that it apportions to California a percentage of the taxpayer's income out of all appropriate proportion to the business of the taxpayer in California. The taxpayer on the other hand will be able to resort to the MATM section merely by showing that the MATM section applies to the circumstances of the taxpayer.[9]

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[8] While the bulk of the telecommunications section rests on case authority, one issue, related to the lack of direct costs in the delivery of telecommunications services, does not. Thus it may be more accurate to say that there are 6 Multistate Audit Technique Manual sections in this category.

[9] See *Appeal of United Parcel Service, Inc*., Cal. St. Bd. of Equal., May 6, 1986, in which the Board of Equalization held that once the Franchise Tax Board and the taxpayer agreed that the standard formula did not properly reflect the business of the taxpayer, the Franchise Tax Board was bound by the plain language of its "interim" trucking industry guideline.

E. The evolving role of the three member Franchise Tax Board.

1. Title 18, California Code of Regulations, subdivision 25137(d).

   This subdivision was added to the regulation in 1978 at the urging of Ken Cory, the State controller and a member of the Franchise Tax Board. In cases deemed appropriate by the three-member Franchise Tax Board it authorizes the Board itself to hear and decide petitions filed under section 25137, instead of having that function performed by the staff. Before the Board hears a petition under the regulation the taxpayer is required to waive, in writing, the confidentiality provisions of Revenue and Taxation Code section 19542 (formerly section 26451).

2. Franchise Tax Board Resolution 2000-10.

   On September 19, 2000, the Franchise Tax Board adopted Resolution 2000-10, declaring that all cases in which the taxpayer has requested a hearing pursuant to section 25137 in which the staff and the taxpayer are not in agreement are appropriate for a hearing before the Board. Hearings are also held before the Board in all cases in which the staff proposes an alternative formula and the taxpayer is not in agreement.

   The Board resolution does not apply to cases in which the dispute between the staff and the taxpayer relates to whether one of the special formulas in 18 CCR 25137-1 through -12 applies to the taxpayer. Those cases are controlled by *Appeal of Fluor Corporation*, *supra,* which holds that for taxpayers in the specified industries the formula in the regulation is the standard formula.

   As a result of Resolution 2000 -10 there is now a new process and a new decision maker involved in 25137 petitions and there will have to be new procedures to accommodate that new step in the process. In addition, since every decision maker brings with them their own life experiences and perspectives, the addition of a new decision maker means that there are bound to be some cases and issues that will be resolved differently than they would previously have been.

   A simple statistic illustrates the procedural impact of Resolution 2000-10. In 1999 the Board held four regular meetings at which it did not deal with a single 25137 petition. During 2000 and the first half of 2001 the Board held seven meetings in which it dealt with nine petitions. On three of the petitions the staff and the taxpayer were in agreement and the Board did not disturb that agreement. The staff brought one petition with which the taxpayer disagreed and the Board agreed with the taxpayer. Taxpayers brought five petitions with which the staff disagreed and the Board sustained the staff in four out of the five cases. On the surface these statistics indicate that the

addition of the Board to the 25137 process has not altered the substance of the decision making process. However there has been one high profile petition in which the Board held for the taxpayer where a traditional 25137 analysis does not appear to explain the result.

Relative to the recent decision on the 25137 petition of the Chevron Corporation, at a minimum, one can say that relief was granted to the taxpayer in a case where the degree of distortion asserted to exist was considerably below the level found to be actionable in reported cases. (The degree of distortion asserted to exist ranged from a high of 10.44 percent in one of the years at issue to a low of 8.54 percent in another of the years.) In addition, the relief granted, factor representation for a non-unitary dividend paying subsidiary, had never before been granted in a California franchise or corporate income tax case. This may indicate that the members of the Franchise Tax Board bring a different perspective to these cases than have the staff, the State Board of Equalization, or the courts.

II. Use of property of another to generate income.

A. The theoretical basis for the property factor.

1. Under the U.S. Constitution a state may only tax that portion of the income of a multistate business that is earned within the borders of the taxing state. The United States Supreme Court has approved the use of formula apportionment as a way of determining the income of a multistate corporation earned within a taxing state. (*Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980).) For taxing purposes the income must be apportioned so that it is in appropriate proportion to the business activities conducted in the state. The theory underlying the use of the formula to apportion business income is that a state may only tax the contribution it has made to the corporation's income.

2. In *Butler Brothers v. McColgan*, 315 U. S. 501, *supra*, the Supreme Court said that property, payroll and sales represented the factors primarily responsible for the generation or business income and that they were, thus, appropriate for inclusion in an apportionment formula. Under UDITPA, the property factor includes both real and personal property owned by the taxpayer. Rented property is included in the computation of the factor at eight times the annual rent. Intangible property is generally not included in the computation of the factor because, as the Connecticut Supreme Court pointed out in *Foodways National, Inc. v. Crystal, Commissioner of Revenue* Services, 232 Conn. 325 (1995), it is often not possible to determine the state in which the intangible property is located or used. One exception to this general rule exists for the financial services industry in which intangible property makes up the overwhelming majority of the property contributing to the generation of income.

3. It has been argued that the purpose of using a property factor in the apportionment formula is to represent the influence of invested capital in the production of income. In fact, however, the property factor in the apportionment formula serves to measure the physical presence of the corporation in the taxing state. This is clear when the rules governing the property factor are examined.

   a. The property which is included is valued at historic undepreciated cost, thus, it does not represent the present value of the invested capital;

   b. Rented property is included in the factor. If the factor's sole purpose were to represent the influence of invested capital in the production of income, rented property would have no place in the computation of the factor. Rather, under the investment of capital theory the rented property would govern the lessor's apportionment of income.

4. UDITPA itself further demonstrates that the purpose of the property factor is to reflect the physical presence of the taxpayer in the taxing jurisdiction since it not only talks about property owned, but property used in the state. Section 10 of UDITPA (Revenue and Taxation Code section 25129) provides:

   > "The Property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period."

5. Pursuant to the language of UDITPA, section10 (Revenue and Taxation Code section 25129(a)) the property included in the factor is that property used to produce the net income subject to apportionment. As a result, the valuation of the property becomes important.

   Property owned by the taxpayer is valued at original cost. The use of original cost obviates any differences which may arise due to varying methods of depreciation. (UDITPA, section 11 and 18 CCR 25130(a)(1).)

   Property which is rented is valued at eight times the annual rent. (UDITPA, section 11 and 18 CCR 25130(b)(1).)

B. California Code of Regulations, Title 18, section 25137(b)(1)(B).

While section 11 of UDITPA values rental property at eight times the net annual rent, the comments indicate that there may be situations where it will be difficult to ascertain a net annual rental value of tangible property because the actual rent is related to services and that the portion attributable to the object is difficult to determine. Likewise, the drafters of UDITPA recognized there may be instances where the actual rent is zero or a nominal sum. In both instances, section 18

may be used to determine a reasonable rental rate. (See Comments to UDITPA, section 11.)

Section 18 of UDITPA, as indicated by the Comments, was intended to give Tax Administrators broad equitable authority to apportion business income fairly among the various states which have contact with the income. To the extent that the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in the state an alternative formula may be employed. Section 18 does not set forth a specific method for determining what the annual rent should be for property factor purposes when the actual rent is zero or a nominal amount. The Multistate Tax Commission ("MTC") has promulgated a regulation (MTC Reg. IV.18.(b)(2)) that sets forth a special rule for determining the rental rate for property factor purposes when the property of another is used for a nominal rent or with no rental charge. The regulation states:

> "(2) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for the property."

California has adopted the provisions of UDITPA section 18 and the general regulation thereunder. At 18 CCR 25137, California has adopted Multistate Tax Commission Regulation IV.18.(b)(2) which sets forth special apportionment formula rules for the property factor including the determination of a net annual rental value when the actual rental value is nominal or zero. Regulation 25137(b)(1)(B) provides:

> "If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rented rate for such property shall be determined on the basis of a reasonable market rental rate for such property."

While the language of the regulation is relatively simple and straight forward, the application of the rule has given rise to a number of issues with respect to when the special formula should be applied and the valuation method to be used when the regulation is applied.

C. Interpretation of the regulation (18 CCR 25137(b)(1)(B)).

1. *Appeal of Proctor & Gamble Manufacturing, Co.*, 89-SBE-028, September 26, 1989.

   The Board of Equalization ("SBE") held that in adopting Regulation 25137(b)(1)(B) the Franchise Tax Board effectively conceded that where property owned by others was used by the taxpayer at no charge, a value for the property must be included in the property factor in order to fairly reflect the extent of the taxpayer's business activity in the state.

A unitary affiliate of Proctor & Gamble, Proctor & Gamble Company of Canada, Ltd. ("P&G Canada") had executed a forest management agreement with the Province of Alberta. Pursuant to the terms of the agreement P&G Canada was granted the right to harvest timber from and have exclusive right to use 3.5 million acres of timberland to which Alberta retained title. On average, P&G Canada harvested trees from 47,200 acres each year. P&G Canada's obligation under the agreement included the payment of $1.50 per cord for the harvested trees, the payment of an annual holding charge of $3.00 per square mile and the payment of an annual forest protection charge of $12.80 per square mile. In preparing the worldwide combined returns for the years in issue, Procter & Gamble included in the denominator of the combined property factor an amount which purported to represent the fair market value of the entire tract of timberland in 1974, the year the land was placed in productive use. At audit the Franchise Tax Board recalculated the denominator of the taxpayer's property factor by excluding the value of the timberland. The basis for the exclusion was the fact the land was not "owned, rented and used" by P&G Canada. Thus, no value associated with it could be included in the combined property factor.

The SBE reversed the adjustment citing the decision in *Appeal of Union Carbide, Corporation*, *supra*. In addition, the SBE rejected the Franchise Tax Board's contention that the taxpayer was required to prove that the standard formula resulted in distortion before the regulation could be applied. The SBE said that, by adopting the regulation, the Franchise Tax Board had implicitly agreed that when the circumstances described in the regulation existed, the standard formula did not fairly reflect the business of the taxpayer. Therefore, further proof was not required. Finally, because the agreement did not preclude any part of the timberland from being "available for or capable of being used during the income year," the SBE concluded that the entire area of the timberland should be included in determining a reasonable market rental value.

The decision in *Proctor & Gamble, supra*, did not address the specific methodology which should be used to determine the reasonable market rental value for the timberland. The issue of the valuation of Canadian timberland was once again raised in *Appeal of Kimberly-Clark Corporation*.

2. *Appeal of Kimberly-Clark Corporation*, State Board of Equalization, May 4, 2000, 2000 Cal. Tax lexis 198; Petition for Rehearing granted November 2, 2000, 2000 Cal. Tax Lexis 555.[10]

   Two of Kimberly-Clark's subsidiaries had operations in Canada. Each of the subsidiaries entered into agreements with the provincial government for the

[10] This was originally an unpublished, non-citable decision. It was subsequently erased from the books when the petitions for rehearing were granted and the appeal was dismissed before the rehearing was held. However, the logic and reasoning of the decision cannot be erased and are worth reviewing since they may point toward the future even if the decision may not be cited.

right to cut timber on government owned land. In Canada the provinces control the majority of the timberland. As a result, there is almost no private sector market for timberland. The agreements set forth the terms for harvesting the timber and covered both productive and unproductive areas. The agreements covered approximately 9.3 million acres of productive land in 1984 increasing to 9.57 million acres in 1985 and 1986. In exchange for the timber rights, Kimberly-Clark incurred obligations with respect to the maintenance of the timberland and was required to make payments to the provincial government. The province collected an "area charge" based on the number of productive acres covered by the license. In addition, the province collected "crown dues" based on the amount of wood actually harvested. Finally. the province collected a "bonus price" which was also based on the amount of wood actually harvested. The bonus price was re-negotiated every few years to reflect the market for harvested timber.

Kimberly-Clark argued that the amounts paid to the Province of Ontario were nominal and that the timber interest should be valued at a reasonable market rental. The taxpayer further argued that the Franchise Tax Board in determining the reasonable market rental should look to the U.S. market. The Board of Equalization, in rejecting Kimberly-Clark's argument, first addressed its prior decision in *Proctor & Gamble, supra*, stating that while the holding charges and the forest protection charges paid by Proctor & Gamble appeared to have been nominal, it did not reach that conclusion as a matter of law and that, as a result, the prior decision did not bind the Board to the conclusion that a reasonable rental should be determined in all cases. Further, the Board disagreed with the argument that there was no Canadian timber market, stating that while it was a unique market, the area charges for the use of the property constituted rent. However, the crown dues and bonus prices did not constitute rent. Rather, these amounts represent royalty payments based on the extraction of natural resources which, pursuant to 18 CCR 25130(b)(4)(B), could not be treated as rent.

Although the Board of Equalization determined that the Canadian timberland was rented, it rejected Kimberly-Clark's assertion that the rental amount was nominal. The Board said that a rental rate would be nominal only if it was wholly disproportionate to a rental rate established by market forces. Here the rental rate was set forth in the agreement and the Board noted that it was similar to the rate paid by other timber companies. The Board further said that the fact that the government controlled the market did not mean that there was not a market and that the relatively low price for Canadian timber compared to the price for U. S. timber was a result of market forces that included governmental involvement. As a result, the Board determined that Kimberly-Clark was not entitled to relief under Revenue and Taxation Code section 25137.

3. *McDonnell Douglas Corporation v. Franchise Tax Board*, 69 Cal.2d 506 (1968).

This case involved pre-UDITPA years. The issue presented to the Court was whether McDonnell Douglas properly computed its property factor when it included in the computation property owned by the United States government. During the years 1941 through 1945 McDonnell Douglas was principally engaged in building aircraft for the U.S. Government. The company manufactured the aircraft at government owned facilities in California and Oklahoma as well as at its own facilities. McDonnell Douglas did not pay rent for the use of the government facilities. In computing the property factor the company included both the tangible property it owned and the tangible government owned property that it used in the production of aircraft. At audit the Franchise Tax Board removed the government property from the property factor.

The Court, in reaching the conclusion that the government-owned property was properly included in the factor, analyzed the manner in which the income was earned. The contracts were cost plus fixed fee contracts and the fee was the same whether the manufacturing was performed in a plant owned by McDonnell Douglas or in a government-owned plant. The use of the plant, regardless of its ownership, was essential to the manufacturing process and the production of income. The Court held that limiting property factor representation to the property owned by McDonnell Douglas would mean that the way in which the company earned its income would not be properly reflected in the apportionment formula and that this would result in distortion.

4. *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., April 5, 1984.

The State Board of Equalization held that a corporation that operated government-owned facilities used to manufacture uranium for the U. S. nuclear weapons program rent free should be allowed to include the property in the computation of the property factor.

Union Carbide Corporation was one of the major contractors on the Manhattan project to develop the atomic bomb during World War II. It continued to be a major contractor in the U. S. nuclear weapons program during the "cold war." Under a contract with the federal government the corporation was responsible for the management, operation and maintenance of four government-owned nuclear facilities located in Kentucky and Tennessee. The services were provided under a “cost plus fixed fee” contract. In computing the denominator of the property factor, Union Carbide included the value of the government-owned nuclear facilities. The Franchise Tax Board argued that the taxpayer could only take advantage of 18 CCR 25137(b)(1)(B) if it first demonstrated that exceptional circumstances existed (which would show that the standard apportionment formula did not fairly represent the business of the taxpayer in California and that as a result it apportioned to California a percentage of the income of the taxpayer out of all appropriate proportion to the business done in the state by the taxpayer).

The Board of Equalization rejected the argument of the Franchise Tax Board on two grounds. First, it cited federal cases for the proposition that the Franchise Tax Board, like the U. S. Treasury, was required to follow its own regulations. Then it reasoned that, by adopting the regulation at issue, which provided for the use of a fair market rental value when a taxpayer used the property of another at no or nominal rent the Franchise Tax Board was demonstrating that it agreed with the taxpayer that the circumstances covered by the regulation were exceptional and that the use of the standard formula was not appropriate.

In the second *Union Carbide* decision, *Appeal of Union Carbide Corporation*, 93SBE-003, January 13, 1993, nine years after the first decision, the Board of Equalization rejected the argument of the Franchise Tax Board that intervening cases had established that a possessory interest in the property by the taxpayer was a prerequisite to the application of 18 CCR 25137(b)(1)(B) and reiterated its holding in the first *Union Carbide* decision.

Having concluded that in the second *Union Carbide* decision that Union Carbide was entitled to treat the government-owned property as rented property and include it in the property factor at a value computed pursuant to Revenue and Taxation Code section 25135 the Board next rejected the Franchise Tax Board approach to determining the "reasonable market rental rate" by reference to a reasonable fee for managing and operating the property. Instead, the Board endorsed the approach taken by the taxpayer that started with the fair market (sales) value of the property and applied a discount rate to that value to arrive at a figure representing the return that a reasonable investor who owned and rented the property would seek on the property. In endorsing the taxpayer's methodology the Board did modify it slightly by requiring that the taxpayer remove from the computations property and income taxes not paid by the Federal government and depreciation that had been factored in elsewhere in the taxpayer's computations..

5 Legal Ruling 97-2, December 17, 1997.

Effective November 1, 1989 the Franchise Tax Board adopted Regulation 25130(b)(4), which provided that royalties paid in exchange for the right to extract natural resources were not to be treated as rent for property factor purposes. Confronted by the need to explain how the new regulation squared with the decision in *Appeal of Proctor & Gamble Manufacturing, Co.*, Cal. St. Bd. of Equal., *supra*, in which payments that appeared to be in the nature of royalties had been included in the rent amount, the Franchise Tax Board issued Legal Ruling 97-2. The legal ruling took the position that the royalty payments included in rent in *Proctor & Gamble* were in the nature of a *profit a prendre* and that they could thus be treated as rent for property factor purposes despite the prohibition against such treatment in 18 CCR 25130(b)(4).

In *Appeal of Kimberly Clark*, *supra,* The Board of Equalization analyzed the reasoning underlying the Legal Ruling and rejected it on the basis that the Legal Ruling was in direct conflict with the regulation[11].

6. The states of Connecticut and New York have also addressed the issue of what constitutes rent for purposes of the property factor.

   a. *Foodways National, Inc. v. Allan A. Crystal*, Commissioner of Revenue Services, 232 Conn. 325 (1995).

      The Connecticut Supreme Court, in reversing the Superior Court, held that amounts paid by a multistate frozen food manufacturer for product storage contracts with public warehouses were properly characterized as "gross rents" that were includable in its corporation business tax "property factor" for purposes of the apportionment formula. The Connecticut statute provides that the property factor consists of a fraction, the numerator of which is a corporation's Connecticut property, and the denominator of which is all property wherever located. Further, the term "gross rents" is defined as "the actual sum of money payable…for the use or possession of property…required to be paid by a lease or other arrangement."

      The product storage contracts at issue provided that a warehouse would supply Foodways with a specified amount of cubic storage space for a given quantity of frozen food, but did not designate a specific section of a warehouse to be set aside for the taxpayer's use. Thus, the warehouse, rather than the taxpayer, determined the place within a warehouse where items were to be stored. The lower court held that a contract for the rental of space could only be a contract for the rental of tangible property if the payment entitled the renter to the use of and control over a specific part of the premise. The Supreme Court rejected that argument, holding that the statute could be read as describing the facts of the case since the rental agreement at issue was an "arrangement" and since it provided the taxpayer with the "use" of the space when all that was required was the "use or the possession of the property." The Court also pointed out that the policy reason for excluding intangibles from the property factor was not present in that the state in which the property was located and used could be determined with certainty.

   b. *Richard Berman, CPA (Advisory Opinion). Commissioner of Taxation and Finance*, TSB-A-94(b)C, Corporation Tax, April 7, 1994.

      New York appears to reach a result contrary to that reached by Connecticut in *Foodways*, *supra*. For the purpose of computing its corporate income tax, a corporation that holds inventory in public warehouses that charge on a rent per day or per carton basis, must

[11] See page 25 for a discussion of *Kimberly Clark*, including the current status of the opinion in the case.

include in the property factor of its business allocation percentage, eight times the gross rents paid for the use of any warehouse space that is designated for use by the corporation and is under its control. However, if the public warehouse storage or rental fees are payable for space not designated and not under the control of the taxpayer, such fees are not included in the gross rents portion of the property factor. (20 NYCRR 4-3.2.)

III. Inclusion of gross receipts from the treasury function in the sales factor**.**

A. Theoretical basis for the sales factor.

In *Container Corporation of America v Franchise Tax Board*, 463 U. S. 159, at 170, *supra*, the Supreme court said that the three factor formula approved in *Butler Brothers v. McColgan*, 315 U. S. 50, *supra*, had become a "…benchmark against which other apportionment formulas are judged"…"because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." (*Id.* at 183.) When the Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act they were guided in the development of the apportionment formula by the fact that many states had already adopted the three factor formula that had been approved in *Butler Brothers.* However, in developing the specific rules for the determination of the sales factor they were also guided by the fact that, if sales were attributed to the state to which goods were delivered, the sales factor would represent the contribution that market states made to the net income of a multistate business. In his article explaining the Act, *The Uniform Division of Income for State Tax Purposes*, *supra*, William J. Pierce said:

> "Manufacturing states probably would prefer a system attributing sales to the place from which the goods are shipped in every case. However, the national conference was of the opinion that such a system would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing state, so that there would tend to be a duplication by such a sales factor. Moreover, it is believed that the contribution of the consumer states toward the production of the income should be recognized by attributing the sales to those states."

In other words, when a corporation markets its goods in a consumer state, the contribution that the consumer state makes to the profitability of the corporation should be recognized by providing sales factor representation to that state. In the case of receipts generated by the sale of intangibles, recognition is given to the state in which the activity that resulted in the sale took place. When the Uniform Act was promulgated it was recognized that while this approach would work reasonably well for services, there were many situations for which it would not work and for which resort to the equitable provisions of section 18 (Revenue and Taxation code Section 25137) would be required.

B. The issue and the response of the Multistate Tax Commission.

The Issue: if a taxpayer purchases for $90 a Treasury bill with a face amount of $100, and one month later sells it for $91, what amount goes into the receipts factor, $1 or $91?

Corporate taxpayers frequently invest excess cash in short-term financial instruments such as United States Treasury instruments, commercial paper issued by corporations, or Certificates of Deposit. Generally a taxpayer will maintain a cash management or treasury function, consisting of specific employees responsible for managing these highly liquid securities. Should these receipts be included in the taxpayer's sales factor and situsued to the state in which the cash management function is located? The frequency and size of the sales can mean that a taxpayer's receipts factor can be quite large, producing a significant increase in the denominator (or numerator) of the receipts factor.

Under UDITPA section 15 (Revenue and Taxation Code section 25134), the sales factor of the three-factor apportionment formula is defined as a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period. Section 1 of UDITPA defines sales as "all gross receipts of the taxpayer" other than those related to items of nonbusiness income specifically allocable to a particular state. A plain reading of the UDITPA and the Multistate Tax Commission's interpretive regulations reveals that the *total gross receipts* from the sale of intangible assets, including short-term financial instruments, must be included in the denominator of the sales factor. (The "throw-out" rule of Regulation 25137(c)(1)(C) ordinarily does not apply because the "income producing activity" can be attributed to the treasury function.)

The states have been concerned that this is distortive of the receipts factor, since it can generate enormous receipts which generate disproportionately small amounts of income when compared to the income generated by the taxpayer's regular business activities.

Beginning in the mid 1990s, the Multistate Tax Commission attempted to address the issue through promulgation of a regulation. To that end, it has proposed an amendment to the definitions section of MTC Reg. IV.2.(a). The MTC proposal excludes certain proceeds--*e.g.,* the repayment of principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instruments; pension reversions; amounts realized on the federally-unrecognized exchanges of inventory--from "gross receipts" even if the income is included in apportionable business income. The proposed regulation has not been finalized so states have not had the opportunity to adopt it reject it.

In addition, the staff of the Franchise Tax Board previously drafted a regulation similar to the draft proposed MTC regulation. The proposed regulation was disapproved by the Board itself on the basis that it was contrary to the plain language of the Code.

C. Are gross receipts from the sale of securities gross receipts for the purposes of UDITPA.

1. The view of the courts.

The reported court cases are all from outside California. Therefore, the reader should bear in mind the limited relevance of those that were decided on the basis of statutory construction if the local statutes differed from the provisions of the Uniform Act.

In *Illinois Tool Works, Inc. v. Lindley*, 436 N.E.2d 220 (1982), the Ohio Supreme Court held that gross receipts from the sale of Treasury bills were properly includable in the sales factor. The Court ruled that the Commissioner had not properly raised the issue of whether Treasury Bill receipts were derived from sales in his notice of appeal and that the Commissioner could not contest that issue. The Court went on to hold that while the (nonUDITPA) statute specifically contemplated inclusion of receipts from the sale of intangible personal property in the sales factor of the apportionment formula, it shed no light on the method to be used to accomplish this. Accordingly, treating sales of intangible personal property the same as sales of tangible personal property was proper.

Similarly, in *Western Electric Company, Inc. v. Norberg*, R.I. Dist. Ct. (6th Div.), A.A. No. 81-391, CCH para. 200-145 (March 30, 1983), *cert. denied*, 461 A.2d 679 (R.I. 1983), the Rhode Island District Court held that the plain language of Rhode Island's prior statute, which closely mirrored UDITPA, required the total gross receipts, including those from the sale of short-term securities, be included in the apportionment formula, however, the decision does not state whether the included receipts included any return or capital element from maturing securities.

One of the earliest cases, often relied upon by the states, is *American Telephone and Telegraph Co. v. Director, Division of Taxation*, 194 N.J. Super. 168 (1984). However, New Jersey's statute for determining the receipts factor differs materially from UDITPA in that "[t]he sales fraction is the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its net income for federal tax purposes...." N.J. Stat. section 54:10A-6(B). Note that instead of referring to "gross receipts," like California's statute and other UDITPA states' statutes, New Jersey's statute refers simply to "receipts." Thus the *American Telephone* court was presented with the issue of whether "receipts" should be

interpreted to mean gross receipts or net receipts, a different issue than whether the plain language of "gross receipts" should be interpreted to mean net receipts. And the court used rules of statutory construction, not a Section 18 equivalent approach, to reach its decision.[12]

The Wisconsin Tax Appeals Commission in *U.S. Steel Corporation v. Wisconsin Department of Revenue,* Dkt. No. I-6578 (May 9, 1985), held that the Wisconsin sales factor, which mirrors UDITPA's, must include gross receipts from sales and redemption of certificates of deposit, U.S. Treasury securities, and other similar short term investments. *American Telephone & Telegraph Co. et al. v. State Tax Appeals Board*, 787 P.2d 754 (Montana Sup. Ct. 1990) provides that only the net receipts from the sale of intangible property should be included in the sales factor. A significant basis for the court's conclusion was the testimony of "[t]wo representatives of the Department "… that the universally accepted interpretation of tax administrators in UDITPA states is not to include gross receipts from sales of temporary cash investments in the sales factor." While it may or may not be the "interpretation of tax administrators," it is most certainly not an interpretation which is "universally accepted."

The Indiana Tax Court has ruled that the denominator of a corporate taxpayer's sales factor should not be increased to include the principal or capital element of investments made outside of Indiana. *The Sherwin-Williams Co. v. Department of State Revenue*, 673 N.E.2d 849 (1996). However, the *Sherwin-Williams* court was following previous Indiana case law addressing what constituted taxable income for purposes of Indiana's personal gross income tax rather than gross receipts for apportionment purposes. (*Sherwin-Williams v. Indiana Department of Revenue*, *supra* (citing *Department of Treasury of Indiana v. Muessel*, 32 N.E.2d 596 (1941)). The statute at issue in the *Muessel* case, like the apportionment statute in *American Telephone*, referenced "receipts" rather than "gross receipts." Because the decision was on the basis of statutory construction, the court said it "was unnecessary for the Court to consider whether the [section 18 equivalent] applies." (*Id.* at 853.)

[12] Even though the decision against the taxpayer was based on construction of the New Jersey statue and not on an analysis of the UDITPA sales factor statute or UDITPA section 18, the court engaged in an analysis, in support of its statutory analysis, similar to that in which one would engage in determining whether such receipts are to be included in the term gross receipts as that term is used in Revenue and Taxation Code section 24120(e). The court said:

> "To include such receipts in the fraction would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account. The bulk of funds flowing back to AT&T from investment paper was simply its own money. Whatever other justification there is for excluding such revenues from the receipts fraction, it is sufficient to say that to do otherwise produces an absurd interpretation of section 6(B). 'It is axiomatic that a statute will not be construed to lead to absurd results. All rules of construction are subordinate to that obvious proposition.'"

In *The Sherwin-Williams Co. v Department of Revenue*, 996 P.2d 500 (Ore. Sup. Ct. 2000)[13] the Oregon Supreme Court ruled that a company's total gross receipts from the sales of its working capital investment securities should be included in the calculation of its total sales for excise tax purposes. At issue was whether the term "sales," as used in the Oregon UDITPA apportionment formula during tax years 1987-92, included all gross receipts from sales of the taxpayer's working capital investment securities and whether former OAR 150-314-665(3) required exclusion of such gross receipts from the calculation of total sales. The court held that ORS 314.610(7) defines "sales" as "all gross receipts of the taxpayer" and the taxpayer's receipts from the sale of securities met that definition. However, the court did not indicate whether any of the receipts at issue represented the return of capital element from maturing securities or from "repos." Therefore it did not indicate whether such transactions were "sales."

The Oregon courts reached similar results in *Pennzoil v. Department of Revenue*, 2000 Ore. Tax LEXIS 6 (Ore. Tax Ct. Mar. 17, 2000). However, in *Pennzoil* as in *Sherwin-Williams* there is no indication that any of the receipts represented the return of capital element from maturing securities or "repos." More recently, the same result was reached for the very taxpayer involved in the first Board of Equalization case to consider the question, concluding that the very same treasury function and activities involved in the *Pacific Telephone* case were held to generate gross receipts. *AT&T, for itself and on behalf of certain combined subsidiaries, v. Dep't of Revenue*, 2000 Ore. Tax LEXIS 17 (Ore. Tax Ct. Aug. 31, 2000). Because the Oregon equitable apportionment statute had been amended so that it only applied to cases of unconstitutionality it was not available to the Department of Revenue. Whether and to what degree the gross treasury function receipts at issue represented the return of capital from maturing securities or "repos" is impossible to tell from the opinion. However the court did refer to a statement by an employee of the taxpayer to the effect that treasury function receipts were generated by the purchase, sale and redemption of securities. The reference to redemption indicates that there was some return of capital element involved.

On the other hand, the Tennessee appellate court in *The Sherwin-Williams Co. v. Johnson*, 01-A-01-9711-CH-00651 (Tenn. Ct. App., Oct. 22, 1998), upheld the revenue commissioner's use of T.C.A. section 67-4-811(g)(1), the equitable apportionment (UDITPA section 18) provision, to exclude from the sales factor denominator the amounts of principal returned on short-term

[13] The Oregon legislature amended the statute in 1995 to exclude from the sales factor "gross receipts" from the sale of intangible assets other than those derived from the taxpayer's primary business activity. The 1999 Legislature again amended Ore. Rev. Stat. section 314.665(6) to provide for the inclusion in the sales factor of the "net gain from the sale, exchange or redemption of intangible assets not derived from the primary business activity of the taxpayer but included in the taxpayer's business income." 1999 Ore. Laws 143 (S.B. 410), effective for tax years beginning after 1998.

investments of excess working capital. The court agreed with the taxpayer that the statute provides for the inclusion in the sales factor of gross receipts from the sale of intangibles; however, court also concluded that including the gross receipts from the sale of short-term securities did not fairly represent the taxpayer's income attributable to the state.

2. The legislative and administrative responses.

   a. Legislative action.

      At least nine states have resolved this question by enacting statutes that either include only net receipts from short-term investment or exclude the resulting receipts entirely, and an additional five states have done so through regulation.[14]

      Query: if the "problem" can be handled by a regulation flatly contrary to the statute?

      In fact, in the Oregon *Sherwin Williams* case, the department relied on a written administrative rule (OAR 150-314.665(3)) in effect since 1971 (the tax years were 1987-1992) which provided for net receipts. The Tax Court granted summary judgment in favor of the taxpayer finding the rule "inconsistent with the statutes."

   b. California administrative cases.

      California first considered the issue in *Appeals of Pacific Telephone and Telegraph*, Cal. St. Bd. of Equal., *supra*. The State Board of Equalization concluded that the receipts generated by the treasury function of the bell telephone system should be included at net. The Board reached this decision by looking at the impact in New York of including these receipts, determining that approximately11 percent of the total income (33 percent receipts factor divided by 3) was apportioned to New York, by these receipts alone, despite the fact that only 2 percent of the overall net income was generated from this activity.

      Thus, the percentage of receipts from Treasury activities was 5 ½ times higher than the income from such activity.

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[14] *See* Ark. Code section 26-51-1403(m)(1) (net receipts only); Colo. Rev. Stat. section 39-22-303(4)(b) (net receipts only); N.C. Gen. Stat. section 105-130.4(a)(7)(d) (net receipts only); Ore. Rev. Stat. section 314.665(6) (net receipts only); R.I. Gen. Laws section 44-11-14(a)(2)(v) (net receipts only); Wis. Stat. section 71.25(9)(f)(5) (net receipts only); Fl. Stat. section 220.15(5)(a) (not in net or gross); Minn Stat. section 290.191(5)(a) (not in net or gross); Ohio Rev. Code section 5733.05(B)(2)(c) (not in net or gross); Haw. Admin. Rule section 18.235-38-03(f) (net receipts only); 86 Il. Admin Code section 100.3380(b)(6) (net receipts only); Md. Regs. section 03.04.08.04(G)(1) (net receipts only); Mont. Admin. R. 42.26.259 (net receipts only); NY Reg. section 4-4.6(e) (is nonbusiness receipts and not included in receipts factor); NY City Reg. section 11-65(e)(2) (is nonbusiness receipts and not included in receipts factor).

This is referred to by some as the “PacTel analysis” and is used in evaluating cases presenting this issue.

In *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith*, 89-SBE-017, *supra*, the issue arose because the taxpayer had substantial financial receipts generating activity as a principal that took place primarily in New York. Nevertheless, the Board of Equalization said the “23-36 percent distortion” (measured by the change in California tax liability) was nowhere near the 250 percent in *Hans Rees'*, *supra*. This conclusion was reached despite the obvious mismatch between the principal and underwriting transactions that took place in New York and the commission transactions that took place in California. No attempt was made to square this distortion analysis with that in *Pacific Telephone*. The Board of Equalization also distinguished *Pacific Telephone* on the basis that Merrill, Lynch’s cash management function was a “fundamental segment of the financial services provided by [the taxpayer],” not an “incidental” part of the business.

There is also a memorandum decision in late 2000 favorable to the taxpayer (*Appeal of Fuji Bank*), presumably on the ground that the brokerage function involved made the case more similar to *Merrill, Lynch, supra,* than to *Pacific Telephone, supra.*

More recently, there was another unpublished (despite a request prior to the hearing from Franchise Tax Board Chief Counsel that the decision be published, regardless of outcome, because of the need for guidance) decision favorable to Franchise Tax Board. *Appeal of Toys R Us* (2000). The taxpayer has filed suit in Sacramento Superior Court. *Toys R Us v. Franchise Tax Board,* (Sacramento Co. #01AS04316).

There is also pending in Superior Court in Oakland a multiple issue case, one issue of which is this gross versus net issue. *The Limited v. Franchise Tax Board*, (Alameda Co. #837723-0. The Limited bypassed the Board of Equalization by filing a claim for refund that was denied by the FTB and then suing for a refund in Superior Court.

D. The application of Revenue and Taxation Code section 25137 to the issue.

1. Burden of proof.

While the burden of proof in a section 25137 (UDITPA section 18) proceeding is on whichever party is attempting to deviate from the plain reading of the statute and that party must “prove that application of the general provisions of UDITPA would lead to an unfair representation of the extent of the taxpayer's activities in this state” (*Appeal of Fluor Corporation,* 95-SBE-016, *supra*), how

to demonstrate the requisite distortion has not been well developed in the cases.

In *Appeals of Pacific Telephone and Telegraph*, Cal. St. Bd. of Equal., *supra*, the Board of Equalization looked at the impact in the state where the relevant income producing activity took place (New York) and concluded that inclusion of the receipts at gross resulted in 33 percent of the sales of the entire Bell Telephone system ending up in New York or, after dividing by three, 11 percent of the total income apportioned to New York based on this activity which produced 2 percent of the net income.

Note the arguably backwards methodology for determining whether the section 25137 statutory test (fair representation of "the extent of the taxpayer's business activity in this state") is met. Query: is it appropriate to measure distortion in California by the impact in New York?

In *Sherwin Williams, supra* in Tennessee the court reached its conclusion that the receipts should be included at net seemingly on a "gut" feeling that something was amiss. No attempt to quantify distortion was made.

In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc,* 89-SBE-017, *supra*, the Board of Equalization said the 23-36 percent distortion was nowhere near the 250 percent that was present in *Hans Rees'*. Despite the obvious mismatch between the principal and underwriting transactions that took place in New York and the commission transactions that took place in California, the Board concluded that relief under Revenue and Taxation Code section 25137 was not appropriate.

Does the *Pacific Telephone* approach result in reverse distortion? In most instances including only the net receipts from investments causes a much smaller proportion of income to be apportioned to the state where the investment activity took place than would be the case if total investment income were used.

On December 13, 2000, the Board of Equalization denied the appeal of *Toys R Us* in which the issues were the inclusion of the return of capital element from maturing securities and the inclusion of gross proceeds from repurchase agreements (repos) in the sales factor. The Franchise Tax Board argued that the gross proceeds from the transactions are not included in the term "gross receipts" and that if they were included, they should be excluded from the sales factor by section 25137 because they distorted the apportionment formula. Because the Board issued a letter decision and did not explain the basis for its decision we do not know whether the Board decided that the receipts at issue were not gross receipts under UDITPA, or whether it concluded that the receipts were UDITPA gross receipts but that including them in the sales factor would be distortive.

The arguments that these receipts are included in the UDITPA definition of the term "gross receipts" is based on:

- Internal Revenue Code section 1271(a), which states that, "amounts received by the holder on the retirement of any debt instrument shall be considered as amounts received in exchange therefore." The analysis is based on the fact that a sale is an exchange and that as a result, the retirement of a security constitutes a sale of the security by the holder back to the issuer.

- An analysis of the decision in *Nebraska Department of Revenue v. Lowenstein*, 513 U. S. 123 (1994), (discussed below) in light of other authority which arguably shows that *Lowenstein* is not dispositive of the status of "repos" for sales factor purposes and that the proceeds of "repos' are the proceeds of a sale that should be included in the sales factor.

The argument that the proceeds are not included within the UDITPA meaning of the term "gross receipts" is based on:

- The argument, further explained below, that Internal Revenue Code section 1271 only applies in situations involving Original Issue Discount.

- The argument that *Nebraska Department of Revenue v. Lowenstein* (1994) 513 U. S. 123 and *Bewley v. Franchise Tax Board*, 9 Cal.4th 526 (1995), make it clear that "repos" represent a loan transaction rather than the sale and purchase of securities.

The argument that inclusion of the treasury function receipts would be distortive was based on the assertion that the treasury function receipts by themselves would result in 28 percent of the income of *Toys R Us* being apportioned to New Jersey, which would have reduced the California apportionment percentage by 28 percent and that this case was more nearly like *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., *supra*, than it was like *Appeal of Merrill, Lynch, Pierce, Fenner & Smith*, Inc. 89-SBE-017, *supra*.

The position that inclusion of the treasury function receipts did not result in actionable distortion was based on the argument that the decision in *Appeal of Merrill, Lynch* changed the 11 percent standard that had been articulated in *Appeals of Pacific Telephone and Telegraph Company* and substituted for it a requirement that the asserted distortion had to at least exceed the *Merrill, Lynch* 36 percent before section 25137 could be applied.

Unfortunately, due to the way in which the Board announced its decision in *Toys R Us* we do not know which of these analyses was accepted by the Board. However, because the taxpayer has filed a suit for refund in Sacramento Superior Court, we may yet get a clearer answer.

There is an alternative way of looking at the *Toys R Us* situation. If only the net receipts from the investment activities are included, the income apportioned to New Jersey would be 37 times lower than the percent of total income represented by investment income. However, including the gross receipts from investments in the sales factor caused the percent of income apportioned to New Jersey to be only 20 times higher than the percent of total income represented by investment income. In other words, including the investments at net underweighted the investment income far more than including the investments at gross overweighted the investment income.

Is the mandate of California Regulation section 25137 to be invoked "only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results" achieved by substituting for one alleged distortion a greater distortion in the opposite direction?

2. Impact on California domiciliaries.

   Any analysis based on the change in California tax liability will often lead to a sufficient distortion that section 25137 relief may be available to a domiciliary because a numerator adjustment has so much more impact than a denominator adjustment.

   For example, in *Toys R Us, supra*, if the treasury activity had been moved from New Jersey to California, and everything else remained the same, the California tax liability would have increased by approximately 270 percent.

E. Receipts from "repos": the impact of *Nebraska Department of Revenue v. Lowenstein* (1994) 513 U. S. 123.

A nonsection 25137 issue, as yet unaddressed in any published case, is the impact of *Nebraska Department of Revenue v. Lowenstein*, 513 U.S. 123, *supra,* on the sales factor issue. *Lowenstein* concerned whether in a typical "repo" transaction Nebraska residents could be taxed on certain interest income. If the interest earned were from U. S. government securities, it would be exempt. That question turned on the characterization of the "repo" transaction. In form, a "repo" involves the purchase of government securities followed by the sale sometime later of those securities back to (the "repurchase" by) the original seller.

In *Lowenstein* the Supreme Court characterized the transaction, for purposes of the narrow question before it, as a lending transaction secured by the

government securities. As such, the interest income earned was from the seller/borrower secured by the government securities, not from the government securities themselves and, therefore, not exempt from Nebraska income tax.

Whether *Lowenstein* applies to the sales factor question at issue here remains an open question. In *In re County of Orange v. Fuji Securities, Inc*., 31 F. Supp. 2d 768 (1998), the court said that *In re Comark v. Resolution Trust Corp*., 971 F.2d 322 (9th Cir. 1992), was still valid law after *Lowenstein*, and as such repurchase agreements convey ownership in the underlying government securities, and thus gross receipts are generated on the resale of those securities. (See also, a 1964 California Attorney General opinion concluding that because of the passage of title a repo transaction is a "simultaneous purchase-sale agreement," not a loan. 44 Op. Cal. Att'y Gen. 140-43 (1964). However, also see *Bewley v. Franchise Tax Board*, 9 Cal.4th 526, *supra*, in which the California Supreme Court described the "repo" process as "…nothing more than financing arrangements.")

F. The return of capital when securities are held to maturity.

Another nonsection 25137 issue involves the holding of debt obligations to maturity, and whether in such an event there is a gross receipt generated at all. Revenue and Taxation Code section 24990 adopts subchapter P of the Internal Revenue Code which includes Internal Revenue Code (IRC) section 1271. Section 1271(a) states: " For purposes of this title – (1) Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefore." It is undeniable that when an instrument is exchanged for money a sale has taken place and since section 1271 states that its mandate applies for purpose of the entire Internal Revenue Code ("this title" being Title 26 of the United States Code) it is clear that the return of capital element constitutes a gross receipt.

The alternative argument is that IRC section 1271 does not deal with the redemption of debt instruments in general but only with the redemption of securities issued with Original Issue Discount and that it no longer reflects the position of the IRC. When the section was adopted in 1954 it was intended to separate Original Issue Discount (OID) received on the maturity of a debt instrument from the gain realized when a debt instrument was bought and then sold on the open market and to ensure that OID from the planned early redemption of a bond would be treated as ordinary income. Internal Revenue Code section 1272 requires that OID must be treated as ordinary income apportioned ratably to the years during which the taxpayer holds the bond. Thus, it can be argued that, despite the language of section 1271, the IRC no longer treats the OID received when a bond matures as the proceeds of a sale. In addition to arguing that that section 1271 only applies to original issue discount, it can be argued that the only definition of gross receipts in either the IRC or the Revenue and Taxation Code is found in the regulation under IRC section 448

that defines gross receipts for purposes of determining whether a corporation can elect the cash method of accounting. The regulation states that the return of capital when a security is redeemed is not part of the gross receipts of the holder. Additionally, decisions in other jurisdictions have held that the return of capital in such circumstances is not part of the gross receipts of the payee. (*Sherwin-Williams Co. v. Indiana Department of Revenue*, 687 N. E. 2d 849 (1996) and *American Telephone and Telegraph Co. v. Director, Division of Taxation*, 194 N. J. Super. 1268 (1994).)

IV. Factor representation for dividends.

A. Due Process and Commerce Clause fairness standard.

While income attribution is inherently a statutory function, that function is subject to constitutional restraints. Specifically, under the Due Process Clause a state may not tax a corporation's property, income or gross receipts unless there is "some definite link, some minimum connection" between the state and the corporation's activities within the state. *Miller Bros. v. Maryland*, 347 U.S.340 (1954). If the state lacks a "minimum connection" or "definite link" with the taxpayer's activities and the income related to those activities, it has not "given anything for which it can ask return." *Wisconsin v. J.C. Penny*, 311 U.S. 435 (1940).

The Commerce Clause also limits the state's ability to tax the income of a multistate and/or multinational corporation. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) the Supreme Court said that a tax will pass Commerce Clause muster if it is a) applied to an activity with a substantial nexus with the taxing state; b) is fairly apportioned; c) does not discriminate against interstate commerce; and d) is fairly related to the service provided by the state.

As discussed above, a fairly apportioned tax must have two attributes. It must be internally consistent, that is, if used by all the states it must result in no more than 100 percent of the business income being taxed. It must be externally consistent, meaning that the apportionment formula actually reflect a reasonable sense of how income is generated. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, *supra*.

If a formula would result in the taxation of more than 100 percent of the income of a multinational business while taxing only 100 percent of the income of an intrastate business, it would have the effect of discriminating against interstate commerce. Therefore the internal consistency requirement is akin to the third prong of the *Complete Auto* test. (See: *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984) and *Tyler Pipe Industries, Inc. v. Washington*, 483 U.S. 232 (1987).)

In contrast, the external consistency test is related to the Due Process requirement that the income attributed to a state be rationally related to the values or activities within the taxing state (see: *Norfolk and W.R. Co. v. Missouri*

State Tax Comm., 390 U.S. 417 (1968) rehg. denied 390 U.S. 1046 (1968)), and it is somewhat akin to the fourth prong of the *Complete Auto* test.

B. Cases interpreting the Due Process and Commerce Clause standards

1. *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980).

The U.S. Supreme Court held that under the Due Process Clause a state could require a non-domiciliary multistate taxpayer to include dividends received from the overseas subsidiaries in its apportionable tax base so long as the taxpayer and the foreign subsidiaries had a unitary relationship. The Court concluded that the "linchpin of apportionability in the field of state taxation is the unitary business principle." The Court said that so long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, the dividends are income to the parent earned in a unitary business and are therefore subject to apportionment.

Although concluding that the dividend income represented income earned in Mobil's unitary business, the majority never addressed the issue of whether a state may include unitary income in the tax base without providing representation in the apportionment formula for the factors which generated the income at the level of the dividend paying subsidiaries. The issue was, however, noted by Justice Stevens in his dissent in which he said:

> "Unless sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated." *Mobil*, 445 U.S. at 461.

2. The issue discussed by Justice Stevens in his dissent in *Mobil Oil* was specifically identified in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, *supra*.

In *Container* the U.S. Supreme Court held that California's worldwide combined reporting system was constitutional as applied to a domestic multinational. In so doing, the Court held that an apportionment formula will not violate constitutional standards so long as, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed, and so long as the factor or factors used in the apportionment formula actually reflect a reasonable source of how the income is generated. In addition, at Footnote 5 the Court acknowledged that Justice Stevens had raised the issue in his dissent in *Mobil.*

3. *Tambrands Inc. v. State Tax Assessor*, 595 A.2d 1039 (Maine 1991).

The State Tax Assessor included dividends received from foreign affiliates in the apportionable income of the taxpayer without a factor adjustment. The Maine Supreme Judicial Court held that the Assessor's formula as it applied to Tambrands violated both the internal consistency and the external consistency tests set forth in *Container*, *supra*. The court reasoned that the foreign subsidiaries would be subject to foreign tax on their income and that the same income would again be subject to tax when it was paid to the parent in the form of dividends and was taxed as income of the parent. The court also said that the water's edge system, as applied by Maine, resulted in the taxation of extraterritorial value. This occurred because the dividends paid by the foreign subsidiaries that were apportioned using only domestic factors were earned in the operation of a world wide unitary business. The exclusion of the factors of the subsidiaries from the apportionment formula meant that recognition was not given to the factors that earned the income and that as a result there was an overapportionment of income to Maine. The Court held that the factors of the foreign dividend paying subsidiaries must be included in the apportionment formula to ensure that the formula reasonably reflected how the income was generated.

The factor adjustment fashioned as a result of this decision is referred to as the "Augusta Formula."

4. *Kraft General Foods, Inc. v. Iowa*, 505 U. S. 71 (1992).

The state of Iowa used a single entity tax scheme that started with net income as defined in the Internal Revenue Code. As a result, dividends paid by domestic subsidiaries were deducted from income while dividends paid by foreign subsidiaries were included in income, apportioned and subjected to tax. The Supreme Court held that, even though the scheme did not necessarily favor Iowa corporations it did favor domestic corporations and that as a result it violated the foreign commerce clause. Thus *Kraft* provided an additional issue, discrimination against foreign subsidiaries, that must be dealt with in determining whether factor representation is required for dividend paying subsidiaries.

5. *Appeal of Morton Thiokol, Inc*., 254 Kan. 23 (1993).

Like Iowa, the Kansas scheme for taxing the income of multistate and multinational corporations started with taxable income as defined in the Internal Revenue Code. However, unlike Iowa, Kansas had a domestic combined reporting scheme rather than a single entity reporting system. This meant that the income of domestic subsidiaries was subject to apportionment and taxation even though the dividends paid from that income were deducted. The taxpayer argued that the decision in *Kraft General Foods v. Iowa,* 505 U.S. 120*, supra*, applied to and invalidated the Kansas taxing scheme. The court rejected that argument saying "Clearly *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially

unconstitutional." The court then recited the argument of the Department of Revenue that the aggregate tax imposed by Kansas on a unitary business would not be less burdensome for a business with domestic subsidiaries than it would be for a unitary business with foreign subsidiaries since the income of the domestic subsidiaries would be subject to apportionment while only the dividends paid by the foreign subsidiaries would be subject to apportionment. The court concluded that there had been no showing that the Kansas method was discriminatory under *Kraft.*

6. *E.I. DuPont de Nemours v. State Tax Assessor*, 675 A.2d.82 (Maine 1996).

As a result of the decision in *Tambrands Inc. v. State Tax Assessor*, 595 A.2d 1039, *supra,* Maine adopted the "Augusta Formula" described below, which allows the use of a world-wide combined reporting methodology to ensure the fairness of the Maine system of taxation. The application of the "Augusta Formula" to DuPont showed that it was not entitled to factor representation for its foreign dividend paying subsidiaries. This meant that the tax of the corporation would be computed in a manner identical to that struck down earlier by the same court in *Tambrands*, *supra*.

The taxpayer argued that the Maine domestic (or water's edge) combined reporting scheme resulted in unconstitutional discrimination against foreign commerce under *Kraft General Foods, Inc. v. Iowa,* 505 U.S. 120, *supra*. The court, relying on the decision of the Kansas Supreme Court in *Appeal of Morton Thiokol, Inc*., 254 Kan. 23, *supra*, held that the scheme was not discriminatory saying:

> "Far from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of 'taxing symmetry' that is not present under a single entity system. Although the dividends paid to parent corporations with domestic subsidiaries are not taxed, the apportioned income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*. Thus, Maine's use of a water's edge combined reporting method distinguishes Maine's taxing scheme from the scheme invalidated by the United States Supreme Court in *Kraft.*"

The court then went on to reexamine its invalidation of the Maine domestic combined reporting system in *Tambrands, supra*. Based on critical comments by Jerome and Walter Hellerstein in *State Taxation* p.9.13[3][a] (2d. ed. 1993 & Supp. 1994) the court concluded that it had not correctly analyzed the tax scheme in *Tambrands* when it applied the internal consistency test and concluded that more than 100 percent of the income of

the taxpayer had been subjected to tax. However the court endorsed the *Tambrands* conclusion that had also been based on an external consistency analysis that the application of the water' edge system could result in the taxation of extraterritorial value in violation of the constitution.

The "Augusta Formula" ensures that when the foreign dividends are included in income the tax liability will not exceed the amount computed under the worldwide combined reporting method.

7. *Conoco, Inc. and Intel Corporation v. Taxation and Revenue Department of the State of New Mexico*, 931 P.2d 730 (1996) petn. for cert. den. 117 S.Ct. 2497 (1997).

New Mexico provided multistate and multinational corporations with four alternative methods of reporting: separate accounting, separate corporate entity reporting, combination of unitary corporations, or federal consolidated group reporting. Both Conoco and Intel elected separate corporate entity reporting. Because, like Iowa, the New Mexico method started with federal taxable income the system by which the tax at issue was imposed was much like that struck by the U. S. Supreme Court in *Kraft*. However New Mexico also applied the "Detroit Formula" when separate entity reporting was elected which gave partial recognition to the factors of dividend paying foreign subsidiaries and had the effect of partially eliminating those dividends from the tax base.

The Court rejected the argument that the United States Supreme Court had implied approval in *Kraft General Foods v. Iowa,* 505 U. S. 120, *supra*, for foreign subsidiary factor exclusion when the income of domestic subsidiaries was subject to apportionment.

The Court also found that, notwithstanding the election offered to the taxpayer and the use of the Detroit Formula, the New Mexico income tax scheme unconstitutionally discriminated against foreign commerce.

The Court found that the use of the Detroit Formula did not eliminate dividends paid by foreign affiliates from the tax base in every case. It then reasoned that because the separate entity reporting system starting with federal taxable income eliminated domestic dividends in every case, the New Mexico separate entity system still discriminated against foreign commerce despite the use of the Detroit Formula. Therefore, the Court held that taxing foreign dividends under the separate corporate entity method was unconstitutional even through the Detroit formula was used.

The court then went on to determine whether the election of methods offered to taxpayers as a threshold matter could save the separate entity method. The Court relied on *Campbell v. Wood*, 18 F3d 662 (9th Cir. 1994), cert. den., 114 S. Ct. 2125 (1994), which it said dealt with an election between

unconstitutional conditions of probation and constitutionally permissible incarceration for the proposition that the right to elect between an unconstitutional method and a constitutional method will not save the unconstitutional method.[15] The problem is that *Campbell v. Wood* at 18 F.3d 662 is a death penalty case in which, among other things, the court said that a defendant could waive his constitutional right to be present during jury selection.

C. Gross distortion versus rationally related.

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, *supra*, the U.S. Supreme Court recognized that there is a permissible "margin of error inherent in any method of attributing income among the components of a unitary business." The issue is what is the proper standard for determining the magnitude of the error or distortion and what is a permissible margin of error.

The Court, in comparing the method used by the state of California in *Container* with that used by the state of North Carolina in *Hans Rees' Sons, Inc.,* set forth the methodology for determining the percentage of error or distortion. That method involves comparing the percentage difference between the apportionment percentage derived by using the method at issue with the apportionment percentage derived through the use of some other better method. The Supreme Court's approach then looks to the relative difference between the income assigned to the state under the competing methodologies rather than at the absolute difference between the methodologies (*i.e.* the average amount of the taxpayer's income attributed to the state).

1. *NCR Corp. v. Comptroller of the Treasury, Income Tax Division*, 544 A.2d 764 (MD 1988).

This was an appeal from the Circuit Court of Baltimore's decision holding that if foreign source dividend and royalty income was subject to apportionment the apportionment factors should be adjusted to reflect the worldwide factors that generated the income. The state also appealed the determination of the Circuit Court that Internal Revenue Code section 78 gross-up income and domestic placement interest income should be excluded from the apportionable tax base.

[15] However also see *Unisys Corporation v. Commonwealth*, 726 A2d 1096 (Pa. 1999), Footnote 4 in which the court said that while the right to choose between two constitutionally infirm apportionment approaches would not save either, when a taxpayer is given a choice between two formulas it cannot complain when the formula that it elects turns out to be unconstitutional in application. This statement and the contrary statement in *Conoco and Intel* can be harmonized on the basis that *Conoco and Intel* dealt with a system that the court determined to be facially invalid while the *Unisys* footnote appears to deal with a situation where the method is asserted to be unconstitutional in application. It is also possible that the conclusion in *Conoco and Intel* rests on an infirm foundation. While it may be correct that an individual may not be forced to choose between constitutionally permissible incarceration and unconstitutional conditions of probation it is well established that individuals and corporations can waive their constitutional rights.

The Appellate Court first rejected the argument of the taxpayer that the Maryland statute required the inclusion of the subsidiary factors. It next rejected as "wishful thinking" the argument that in Footnote 5 of the decision in *Container Corporation v. Franchise Tax Board*, *supra*, 463 U. S. 159 the United States Supreme Court had adopted the dissent by Justice Stevens in *Mobil Oil Corporation v. Commissioner*, *supra*, 445 U. S. 425 in which he said that apportionment of dividends required inclusion of subsidiary factors in the apportionment formula. The court further pointed out that including the factors of royalty paying subsidiaries would be no different that including the factors of independent third party entities to whom the taxpayer licensed its processes or patents and rejected the inclusion of such factors. However, at that point the court acknowledged that it would be fairer to include factor representation for the dividend paying subsidiaries. Moreover the court stated that as a result of other changes that would result from its opinion, it was unable to determine whether the resulting disproportionality was of constitutional magnitude. As a result it remanded the case to the lower court for a determination on that point saying that if such disproportionality existed, a modification must be made to the apportionment formula.

2. *NCR Corporation v. Commissioner of Revenue*, 438 N.W.2d 86 (MN 1989), petn. for cert. den. 493 U.S. 848 (1989).

   NCR argued that the income from royalties paid by licenses as well as dividends and interest it received from its foreign subsidiaries should be excluded from the tax base. In the alternative, NCR argued that if the interest and dividend income was included in its gross income, the payroll, property and sales of the subsidiaries from which that income was earned should be included in the denominators of the apportionment factors.

   The Minnesota Supreme Court looked to the Maryland decision in *NCR Corp. v. Comptroller of the Treasury*, 544 A.2d 764, *supra*, and found its construction of statutory language persuasive. The Court said that the Minnesota statute reflected a legislative objective to maximize the collection of income taxes from corporations doing business in Minnesota. Based, on this legislative objective, the court determined that the income payments from licensees and subsidiaries were properly included in the tax base.

   Second, the Court agreed with the Maryland Court with respect to the apportionment factor. The term “taxpayer” as used in the Minnesota statute did not include the foreign subsidiaries and the statute did not contemplate the inclusion in the apportionment formula of the factors of foreign affiliates not subject to taxation in Minnesota.

   The Court also rejected NCR’s Due Process Clause argument concluding that NCR failed to meet its burden of proof to sustain either the internal or external consistency challenge. The Court concluded:

> "NCR has failed to demonstrate by clear and cogent evidence that the relatively small resulting disparity in tax fails to properly reflect how the income was generated, or, that an excessive amount of that income was attributed to Minnesota under proper application of its apportionment statute to be constitutionally impermissible."

NCR also argued that the possibility of multiple taxation violated the Foreign Commerce Clause. The Court responded to the argument by saying that it was recognized in any income tax apportionment formula that a continual risk of multiple taxation exists, but a constitutional analysis does not require a state to apply a different formula simply because the risk may be lower. With respect to the argument that the formula impaired federal uniformly, the Court said that NCR had provided no evidence of any clear federal directive which would precludes Minnesota from applying its apportionment formula as it did.

3. *NCR Corporation v. South Carolina Tax Commission*, 402 S.E.2d 666 (S.C.1991) and 439 S.E. 2d 254 (S.C. 1993) petn. for cert. den. 114 S.Ct. 2763 (1994).

   This case was heard twice. In the first iteration reported at 402 S.E.2d 666 the court rejected the argument of the taxpayer that the South Carolina statute contemplated the inclusion in the apportionment formula of the factors of foreign subsidiaries that paid royalties and interest to the parent. It also rejected the arguments of the taxpayer that the failure to include the factors of the subsidiaries in this foreign commerce context subjected the taxpayer to the risk of double taxation of the type declared unconstitutional in *Japan Line v. County of Los Angeles*, 441 U, S. 234 (1979). The court then engaged in an external consistency analysis and concluded that as applied, the formula did not fairly reflect how the income at issue was generated. However, it went on to say that it did not have sufficient information to determine whether the degree of error was outside the "substantial margin of error" permitted in cases involving the use of formula apportionment. The case was remanded to the lower court for a determination on this point.

   In the second iteration of the case reported at 439 S. E.2d 254, the court sustained the methodology by which the trial judge determined the magnitude of the error caused by the failure to include the factors of the interest and royalty paying subsidiaries in the apportionment formula and said that the magnitude of the error, 27.9 percent, was within the permissible margin of error and that as result there was no "gross disparity" and no violation of the Due Process Clause.

4. *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, 857 P.2d 788 (N.M. App. Ct. 1993); petn. for cert. den. 114 S. Ct. 2763 (1994).

The New Mexico Appellate Court likewise rejected NCR's argument that the taxation of royalties, interest and dividends received from foreign subsidiaries violated the Foreign Commerce Clause. With respect to the factor adjustment argument the Appellate Court held that NCR failed to show by clear and cogent evidence that the income attributed to New Mexico was disproportionate to the business transacted in the state. Absent such a showing there was no basis for factor relief.

5. *American Telephone & Telegraph Co. v. Department of Revenue*, 422 N.W.2d 629 (Wis. Ct. App. 1988).

   The Wisconsin Appellate Court decision in *AT&T* is an example of a state court decision holding that subsidiary factor representation is required despite the fact that there was no finding relative to a specific percentage of distortion or disproportionality.

   AT&T argued that the application of the standard three factor formula by Wisconsin did not fairly represent the taxpayer's business activity in the state. The Department included dividends paid to AT&T in the company's apportionable tax base without including the apportionment factors of the subsidiaries in the apportionment formula. AT&T argued that the Department was required to treat the parent and its subsidiaries as a single entity and determine its income tax liability by utilization of a combined report. In the alternative, AT&T argued that the Department must include in the denominator of its property factor the book cost of the investment in and advances to the subsidiaries generating the income at issue. In turn, the Department argued that the apportionment statute limited the property factor to the taxpayer's real and tangible personal property, that the taxpayer was AT&T rather than the subsidiaries, and that what AT&T owned was intangible property (the stock of the subsidiaries) rather than tangible property and that as a result the value of the investment in the real and tangible personal property of the subsidiaries could not be included in AT&T's property factor.

   The Appellate Court, in rejecting the Department's argument, noted that the argument ignored the nature of the unitary business. The Court concluded that the legislature, in referring to the "taxpayer's" real and tangible personal property, had not affirmatively intended to limit the property factor of the apportionment formula to real and tangible personal property owned or used by the parent corporation of a unitary business and found that neither the statute nor Wisconsin case law excluded from the apportionment formula the value of AT&T's investment in the real and tangible personal property of its subsidiaries.

   The Court then turned to the question of whether the formula fairly reflected AT&T's business activity in the state. The court said that while the formula passed the internal consistency test, it did not reasonably reflect the manner in which income was generated. The Court noted, that although dividends

received from functionally integrated subsidiaries were included in apportionable income, a state could not tax such income by use of an apportionment formula unless the formula bore a reasonable relationship to the corporate activities in the state. The Court in the instant case found that the required reasonable relationship did not exist.[16]

6. *Unisys Corporation v. Commonwealth of Pennsylvania*, 726 A.2d 1096 (Pa. 1999).

   This is an interesting and unique case in which the taxpayer surmounted three separate hurdles to secure factor representation for dividend paying subsidiaries.

   The Pennsylvania Franchise Tax is imposed on the capital stock value of every out-of-state corporation doing business in Pennsylvania and is designed to tax only the business conducted in the Commonwealth. Unisys owned either directly or indirectly the stock of more than 100 domestic and foreign corporations. Under the statute, the tax base included the value of the investments and the dividends received from those investments. Also, under the statute, the taxpayer could elect either of two apportionment formulas. Under the formula elected by Unisys only the tangible property, the payroll and the sales of Unisys itself were included in the apportionment formula. Had Unisys elected the single factor formula, the value of the intangible property owned by it would have been included in the formula.

   Unisys argued that both the Due Process and Commerce Clause require the inclusion of the property, payroll and sales of its affiliates in the apportionment formula because excluding these items was fundamentally unfair. In the alternative, Unisys argued that it was entitled to statutory equitable relief under the special apportionment provision of section 401(3)2.(a)(18) of the Tax Code (section 18 of UDITPA).

   First the court acknowledged that where a taxpayer has the right to choose an alternative that passes constitutional muster it cannot later complain if it chooses an alternative that has an unconstitutional result. However, the court then either ignored the election issue or, in light of its subsequent action, concluded that both of the alternatives would have resulted in actionable distortion.

[16] While the court did not specifically discuss the degree of disproportionality and did not analyze it in terms of the *Hans Rees'-Container* standard, a careful reading of the decision indicates that the court was satisfied that there was substantial disproportionality. In its external consistency analysis the court recited figures which read together tend to demonstrate the existence of gross disproportionality. For example, AT&T reported $500 million in earned income and $3 billion in intangible income; the Wisconsin percentage of AT&T property was 1.5 percent while the Wisconsin percentage of AT&T unitary group property was .1 percent or one fifteenth of the AT&T percentage; AT&T had 235 employees in Wisconsin while AT&T had a total of 34,900 employees and the unitary group had over 735,000 employees.

The Court next discussed the internal consistency and external consistency tests articulated by the United States Supreme Court. The court recited the disparities found by the court to exist in *Hans Rees' Sons, Inc v. North Carolina*, 283 U. S. 123, *supra*, (300 percent) and *Norfolk & Western Railway Company v. Missouri*, 390 U. S. 317, *supra*, (266 percent) in which the Court granted relief, and *Moorman Manufacturing Company v. Bair*, 437 U. S. 267, *supra*, in which relief was denied (48 percent). Based on that comparison the Court concluded that the difference of 44.5 percent between the results of the Pennsylvania three factor formula and the Unisys combined reporting approaches was not sufficient to demonstrate that the result of the three factor formula was "…outside of the constitutional margin of error delineated by the Supreme Court."

Having come down on the side of the taxpayer on the first issue and on the side of the state on the second issue the Court went on the determine whether the Pennsylvania equitable relief statute, which was modeled on section 18 of UDITPA, contained a different standard of disproportionality for granting relief, or to put it in the terms used by the Court, whether what constitutes unfairness under section 18 differs from what constitutes unfairness under the constitution. Without examining the results in other states that had dealt with the issue, a failing for which it was trenchantly criticized in the dissent, the court answered the question in the affirmative saying of the 45 percent difference "…we simply cannot say that an allocation so far at variance 'fairly represents the extent of [Unisys'] business activity in this State.'" The Court went on to conclude that the failure to grant relief under these circumstances constituted an abuse of discretion by the Department.

The Court pointed out that each case must be decided on its own merits and that section 18 relief may not be granted in all cases. Moreover, it specifically said that inclusion of subsidiary factors in the apportionment formula was not the only remedy available to the Department.

D. The consensus of the cases.

A review of the reported cases in which the issue of factor representation for subsidiaries that make dividend, royalty or interest payments to U. S. parents has been discussed shows that there are two broad questions that that must be answered:

- Whether under the decision in *Kraft General Foods, Inc v. Iowa,* 505 U. S. 71, *supra*, the elimination of domestic dividends, royalties or interest requires factor representation or other relief for foreign source dividends, royalties or interest.

- Whether failure to include the factors of the foreign dividend, royalty or interest payers results in an unfair representation of the business activities

of the taxpayer and whether that in turn causes a gross disproportionality in the apportionment of the taxpayer's business income.

1. The *Kraft* issue (*Kraft General Foods v. Iowa*, 505 U. S. 71 (1992)).

   Most of the cases in which the *Kraft* issue has been discussed have arisen in states that have some form of water's edge/domestic combined report in which the income of domestic subsidiaries is included in the tax base subject to apportionment. As a result, in the majority of the cases the courts have distinguished the cases from *Kraft* on the basis that subjecting the income of the domestic subsidiaries to taxation creates a symmetry that was missing in *Kraft.* Thus the apportionment statutes at issue were not found to be facially discriminatory. This in turn means that the taxpayer had the burden of demonstrating the existence of disproportionate apportionment of income to the taxing state in excess of the constitutional standard. In only one case has the taxpayer been able to carry that burden. (*A.T.& T. v. Wisconsin Department of Revenue*, 422 N. W.2d 629, *supra*.) Examples of the cases in which the taxpayer has not carried the burden of proof on the issue of disproportionality are: *NCR Corporation v. Comptroller*, 313 Md. 118 (1988); *NCR Corporation v. Commissioner*, 438 N. W.2d 86 (Minn. 1989); *NCR Corporation v. New Mexico Tax and Revenue Department*, 856 P.2d 983 (1993); *NCR Corporation v. South Carolina Tax Commission*, 312 S.C. 52 (1993); *E.I. DuPont de Nemours & Company v. State Tax Assessor*, 675 A.2d.82 (Me. 1996); *Caterpillar Financial Services Corporation v. Whittley*, 288 Ill. App.3d 389 (Ill. 1997); *Caterpillar, Inc v. Commissioner of Revenue*, 568 N.W.2d 695 (Minn. 1997); *Caterpillar Inc. v. New Hampshire Department of Revenue*, 741 A.2d 56 (1999); and *Gillette Company v. Commissioner of Revenue*, 425 Mass. 670 (Mass. 1999).

   In at least one case involving a water's edge combined reporting system but involving royalties rather than dividends, the court said that the proper basis of comparison was between unrelated domestic entities and the foreign subsidiaries because by excluding the foreign subsidiaries from the combined report the legislature had simply decided to treat them as unrelated entities. (*Caterpillar, Inc. v. Commissioner of Revenue*,568 N.W.2d 695 (Minn. 1997).)

   Where the case involves a separate entity reporting system and uses the Internal Revenue Code definition of net income as the starting point, the courts have generally followed *Kraft* and have found the apportionment formula to be facially discriminatory and have required relief. (See, *Dart Industries, Inc. v. Clark*, 657 A2d 1062 (RI 1995) and *Conoco, Inc. and Intel Corporation v. Taxation and Revenue Department of the State of New Mexico*, 931 P.2d 730, *supra*, petn. for cert. den. 117 S.Ct. 2497 (1997).)

   In the last category of case, so far represented only by *Unisys Corporation v. Commonwealth*, 726 A.2d 1096 (Pa. 1999), the court found, as had the majority of courts considering the issue, that exclusion of the factors of the

foreign dividend, royalty of interest paying subsidiaries from the apportionment formula meant that the formula did not fairly reflect the business activities of the taxpayer. However, unlike all of the other courts that have considered the issue, the Pennsylvania supreme court found that the standard for relief under UDITPA section 18 is lower than it is under the constitution.

To summarize the situation then, it appears that as a general rule the courts believe that apportionment of foreign source dividends without factor representation does result in a degree of distortion but that generally speaking the degree of distortion is not sufficient to require relief under either the constitution or UDITPA section 18. In those situations to which *Kraft General Foods, Inc. v. Iowa*, *supra*, applies, there is facial discrimination and it is not necessary for the taxpayer to demonstrate the existence of gross disproportionality. However, according to the majority of the cases reported to date, *Kraft* does not apply to those situations in which there is domestic combined reporting and the income of the domestic subsidiaries is included in the measure of tax.

E. What is appropriate relief?

1. The "Detroit Formula."

The alternative apportionment method known as the “Detroit Formula” provides for inclusion of the factors of the dividend paying corporation in the ratio of dividends paid to book income of the paying corporation. In general, the method works as follows:

> Include in the denominator of the property, payroll and sales factors, the property, payroll and sales of the taxpayer’s controlled foreign subsidiaries in the same ratio that the net dividends received from the subsidiaries bear to each subsidiary’s entire net profits. The ratio cannot exceed 100 percent of the profits.
>
> With respect to a year in which a loss is incurred, the ratio is net dividends received divided by the retained earnings at the beginning of the tax year.

The methodology of the Detroit formula gives rise to a number of issues:

> Should the income of the foreign subsidiaries be reduced by foreign income tax paid?
>
> Is the proportionate contribution of the foreign affiliates to the property, payroll and sales computed on a combined basis (*i.e.* the royalties, interest income and dividends paid by all foreign subsidiaries are combined and then divided by the combined income of all subsidiaries to determine the ratio).

2. The "Augusta Formula."

   The Augusta formula was devised by Maine State Tax Assessor in response to the Maine Supreme Court decision in *Tambrands, Inc, v. State Tax Assessor*, 595 A.2d 1039, *supra*. If a taxpayer receives dividends from a unitary foreign affiliate, the taxpayer's Maine income tax liability is determined by making and comparing the results of three separate calculations.

   a. First, the income of the taxpayer is apportioned using the water's edge method and including the foreign source dividends in the income subject to apportionment.

   b. Second, the income of the taxpayer is apportioned using the world wide combined reporting method in which the income and factors of foreign unitary subsidiaries are included in the computation.

   c. Third, the water's edge method is used, but the foreign source dividends are excluded from the income subject to apportionment.

   If the tax assessed using the water's edge method, with the dividends included, does not exceed the tax computed using the world wide combined reporting method, the water's edge method will be used and the dividends will be include in the income subject to apportionment. If the tax assessed using the world-wide combined method is lower than the amount computed using the water's edge method with dividends included then the world wide combined method is used. However, if the world-wide combined report method results in a lower assessment than would the water's edge method with the dividends excluded then the water's edge method is used. Thus the water's edge method with the foreign source dividends excluded becomes a floor below which the tax is not allowed to fall.

   If the worldwide combined reporting yields a higher Maine income tax than the statutory water's-edge combined reporting method, the statutory computation is used even though foreign source dividends are included and there is no factor representation**.**

3. Separate accounting.

   Separate (geographic) accounting is a technique which carves out of the taxpayer's overall business the activities taking place, the property employed and the income derived from sources within a single state and by analyzing and attributing the profits attributable to that portion of the business. See: *Exxon Corporation v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980) and *The Texas Company v. Cooper*, 107 So.2d 676 (LA 1958).

   The theory of separate accounting is based on the premise that a multistate taxpayer can be divided into separate segments so that the activities within one taxing jurisdiction may be segregated from the activities in other

jurisdictions. Thus, the income is taxed based on the business activities within the state.

Separate accounting requires the identification of all items of income and costs related to the taxpayer's activities within the taxing jurisdiction and then the computation of a statewide net income from these items.

There are two general methods used to compute the separate income of a multistate manufacturing business.

Method one ascertains the actual cost of the manufacturing and adds to it a reasonable profit. The profit may be determined by looking to the profit earned by similar corporations in comparable businesses.

The second method ascertains the price at which the articles manufactured may be purchased from another manufacturer. That price is then used to establish a selling price from which manufacturing costs are then subtracted to arrive at the income earned.

V. Intangibles.

A. Sourcing of sales.

Revenue and Taxation Code section 26136 provides that receipts generated by intangibles must be assigned to the state in which the activity that produced the income occurred. When that activity occurs in two or more states the receipts are assigned to the state in which the greatest portion of the income producing activity occurred. The regulations implementing the Code section provide that the location of the income producing activity must be determined based on direct costs, determined in a manner consistent with generally accepted accounting principles. Thus, instead of looking at the market as is done with sales of tangible personal property, one looks at the location of the income producing activity. However, income producing activity in a location may only be taken into account if it is possible to identify direct costs related to the activity in the location and then only to the extent of those direct costs. These general rules are applied to receipts generated by the rental of tangible personal property or real estate, by the sale of intangible property, by providing personal services, by providing non-personal services, by licensing the use of a patent, copyright, or similar intangible or through an investment in a debt or equity security.

As described above (see I. D. 2. b.) the regulations, at 18 CCR 25136, provide special rules for assigning receipts generated by the lease or rental of real estate, the rental of tangible personal property, and the provision of personal services. Thus, there are three categories of receipts that must be assigned under the standard provisions of the 25136 implementing regulations: receipts generated by non-personal services, receipts generated by the licensing of a patent, copyright, etc. and receipts generated by investments.

When the income producing activity takes place in a single state the assignment of receipts for sales factor purposes is relatively straight forward. However, when the activity takes place in two or more states the issue of direct cost arises and the assignment of the receipt becomes more complex and the possibility of distortion becomes greater.

If a patent is licensed to a single user, the research and development costs that went into its development are direct costs, even under a narrow financial accounting definition since they are directly related to the single transaction. If the same patent is licensed to two or more users, those same research and development costs will no longer be direct costs because they would not be incremental costs, but would instead be apportioned between the two or more transactions. The only direct costs remaining would be those related to the negotiation and execution of the licensing agreements and the cost and situs of those activities as compared with the cost and situs of the research, and development activities may not be representative of the location of the business activities of the taxpayer.[17]

In *Scripto, Inc. v. Carson*, 362 U. S. 207 (1960), the Supreme Court held that a Georgia corporation selling novelty writing instruments in Florida through independent contractors was subject to tax in Florida. Since the items being sold were tangible personal property Scripto would have had sales factor representation in Florida (assuming that Public Law 86-272 did not prevent the imposition of income tax liability). If, however, Scripto had been selling intangibles it would have had no sales factor representation in Florida because under the regulation at 18 CCR 25136(b) services of independent contractors do not constitute income producing activity.

When a corporation has an active treasury function that buys and sells securities from a location in a single state, assignment of the receipts to that state for sales factor purposes is relatively straight forward (although there is the issue of whether net or gross receipts should be included). However, when corporation buys and holds the stock of an integral but non-unitary subsidiary or a unitary subsidiary that is not included on a combined report and it receives dividends from that subsidiary it will generally not receive sales factor representation even though the dividends will be business income. This is because the activities of the parent will generally not be income producing activity as to the dividend paying subsidiary.

[17] In the unpublished opinion in *Appeal of Adobe Systems, Inc*., Cal. St. Bd. of Equal., August 1, 1997, the Board of Equalization, in determining whether the income from the licensing of software should be allocated to Massachusetts or to California for sales factor purposes, did include research and development cost in its list of California based income producing activity. However, it also included other items and said in a footnote that the Massachusetts activities may not have been income producing activities as envisioned by the regulations.

The potentially distortive effects of Revenue and Taxation Code section 25136 are especially significant in the evolving world of internet and other electronic service providers. Even if taxable nexus is established with a market state, the standard formula will apportion little income to the state because such services frequently have few employees and little property in the market states. And because there is rarely an increase in cost directly attributable to a single customer there would be no direct costs to be used to determine the situs of the greater proportion of the income producing activity. It is for this reason that the Franchise Tax Board has included guidance in the Multistate Audit Technique Manuel for assigning the receipts of telecommunications companies. The guidance indicates that the best way to assign the receipts is by applying to them a ratio computed by dividing the "net plant facilities" of the telecommunications company in the taxing state by the total "net plant facilities of the taxpayer."

B. Property factor representation for intangibles.

Revenue and Taxation Code section 25129 provides that only tangible property is included in the property factor. However, it is clear that for financial institutions such as banks, intangible property constitutes the bulk of the income producing property used in the business and to exclude such property from the apportionment formula would mean that the formula would not accurately represent the business of the institution. For that reason California and the Multistate Tax Commission have adopted regulations under which the intangible income generating assets of financial institutions are included in the property factor. The California regulation (18 CCR 25137-4.2) applies to banks and financial corporations (as defined in 18 CCR 23183 as a corporation that generates more than 50 percent of its income from dealings in money or moneyed capital in competition with national banks).

While banks and financial corporations receive property factor recognition under the special regulation, there are few reported cases in which intangibles have been added to the property factor under the general provisions of UDITPA section 18. In *Appeal of Texaco, Inc*., Cal. St. Bd. of Equal., January 11, 1978, the Board of Equalization denied the request of Texaco for inclusion of intangible property in the property factor for an income generating subsidiary that had no tangible property, no payroll and no sales. In denying the appeal of the taxpayer the board said "[I]n cases not involving the finance industry…respondent has included intangibles in the property factor when appropriate. (*Appeal of R. L. Polk & Co.*, Cal. St. Bd. of Equal., Oct. 26, 1944.)" However, an examination of *Polk* shows that it was a pre-UDITPA case in which the Franchise Tax Board included "intangible" work in progress in the numerator of the property factor. Because it was a pre-UDITPA case there was not the presumption in favor of the standard three factor formula that must be overcome before Revenue and Taxation code section 25137 can be invoked. In *Appeal of Retail Marketing Services, Inc*., 91-SBE-003, *supra*, the Board of Equalization held that the grocery coupons held by a coupon redemption service were intangible property and that the taxpayer had

not demonstrated that intangibles should be included in the property factor because it had not demonstrated that the standard apportionment formula distorted the extent of the taxpayer's business activities in California.

In *Crocker Equipment Leasing, Inc. v. Department of Revenue*, 314 Ore. 122 (1992), the Oregon Supreme Court held that the Oregon formula for apportioning the income of financial corporations, which was the same as the standard three factor UDITPA formula, was distortive and that the taxpayer was entitled to include in the formula the intangible assets that generated 98 percent of its income. However, in most of the reported cases the courts have rejected the efforts to secure property factor representation for intangibles on the basis that the taxpayer did not carry its burden of demonstrating that the standard apportionment formula did not fairly represent the business activity of the taxpayer.

In *Twentieth Century-Fox Film Corporation v. Department of Revenue*, 299 Ore. 220 (1985), the Oregon Supreme Court did approve the action of the Department of Revenue in including in the property factor the intangible value of films distributed by the taxpayer in Oregon. Despite the fact that Oregon had adopted the Multistate Tax Commission regulation on the film industry, the court sustained the Department on the basis of an analysis demonstrating that the standard formula did not fairly represent the business of the taxpayer in the state.

In *Eastman Kodak Company v. Commonwealth of Pennsylvania*, 146 FR 2000, 2000 Pa. Tax Lexis 418 (2000), the Commonwealth Court of Pennsylvania denied the taxpayer's request to include an intangible property factor in the apportionment formula. Kodak had divested itself of subsidiaries resulting in a substantial net gain in apportionable income. Kodak argued that it was unfair under the Pennsylvania equitable relief statute to apportion these gains by the standard formula since that formula did not give recognition to the intangible values that generated the income. The court rejected the argument saying that Kodak had not shown that the standard formula did not fairly reflect the activities of the taxpayer in Pennsylvania.

In *Random House, Inc. v. Comptroller of the Treasury*, 310 Md. 696 (1987), the court held that the taxpayer had not carried its burden of proof to show that the standard formula was distortive where income generated by intangible "subsidiary rights"[18] was apportioned by the standard formula that did not include intangible property in the property factor. The taxpayer had included the subsidiary rights income in its apportionable income. When the tax administrator included the income in the apportionable tax base the taxpayer argued that to do so without providing recognition in the apportionment formula for the intangible property that generated the income was unfair. The court first pointed out that

[18] "Subsidiary rights" is a term of art in the book publishing business. The term refers to the right of the publisher to generate income from a written work subsequent to its publication as a book, as for example by serializing it in magazines or newspapers, making sound recordings, creating commercial tie-ins etc.

the taxpayer had not demonstrated the value of the subsidiary rights and then rejected the taxpayer's assertion of unfairness, apparently on the basis that the taxpayer had not carried its two-fold burden of showing the value of the subsidiary rights and that the standard formula did not fairly represent the business of the taxpayer in Maryland.

In *Foodways National, Inc. v. Crystal, Commissioner of Revenue*, 232 Conn. 325, *supra*, the court supported its determination that empty space was tangible property for property factor purposes, in part, by explaining the policy reason for excluding intangibles from the property factor and pointing out that those policy reasons did not apply to undesignated space in a warehouse. The court quoted J. Warren, Income Taxes: Principles of Formulary Apportionment, Tax Management Multistate Portfolio Series section 1150.5B (1994) to the effect "…that such assets often cannot be said to be located in a particular state."

VI. The processing of 25137 petitions.

Prior to the adoption Resolution 2000-10 by the Franchise Tax Board the procedures for the processing of 25137 petitions were informal and simple. A 25137 issue could be raised and resolved in the protest process, in the appeal process, in a suit for refund or in a petition under section 25137. The filing of an actual petition probably occurred in small minority of the cases in which the issue was raised and the fact that a taxpayer failed to file a petition was typically not raised as a procedural defense by the FTB in appeals or court proceedings.

A. The current process and procedure.

The involvement of the three member Franchise Tax Board in the process has created a more structured process since it is now necessary to identify all cases in which section 25137 issues are being raised so that the Board can be informed and so that, if necessary, the case can be presented to the Board for a decision.

1. What constitutes a petition?

A 25137 issue may be raised in a protest or in a claim for refund or in a separate petition concurrent with the protest or claim for refund. In addition, as a matter of practice taxpayers have been permitted to raise issues under section 25137 when appealing the denial of a protest to the Board of Equalization. Because of the informal nature of the process that has existed the Franchise Tax Board has not objected when taxpayers have raised the issue for the first time on appeal

As a result of the informal nature of the process all that has been required for a valid 25137 petition is a clear statement in a stand alone petition, a protest, a claim for refund or an appeal that the standard formula does not fairly

represent the business of the taxpayer in the state or that the income apportioned to the state by the standard formula was out of all appropriate proportion to the business done in the state by the taxpayer. In addition, it must clearly articulate the relief sought by the taxpayer.

Because of the informal way in which the issue could be raised there has been no need for a requirement that petitions be submitted to any particular place in the department.

2. When may a petition be filed?

A petition filed in response to a notice of proposed assessment (in support of or in conjunction with a protest) must be filed within the time provided for the filing of a protest. However, so long as the protest raises the 25137 issue, a petition setting forth the factual basis and legal arguments supporting an assertion of distortion in the protest will be timely so long as it is filed before the Notice of Action on the protest is issued by the Franchise Tax Board. When a 25137 issue is raised in a claim for refund the same principles apply. The issue must be raised in, before, or concurrently with the claim for refund and the factual basis and legal argument supporting the assertion of distortion must be provided to the FTB before the notice of action is issued on the claim. Because an appeal of the denial of a claim for refund cannot raise issues not raised in the claim itself a 25137 issue may not be raised for the first time in an appeal of a claim denial or in a refund suit following such a denial.

A 25137 issue may be raised by the taxpayer during the audit process. However, if the auditor rejects the position of the taxpayer the taxpayer must again raise the issue in a protest, claim for refund or as a separate stand alone petition.

In addition, a taxpayer may file a petition with a return reporting tax computed either pursuant to the standard formula from which the taxpayer is seeking relief, or pursuant to the proposed alternative formula. A taxpayer can even file a petition before filing a return. However, due to the need to secure approval from the three member Franchise Tax Board before the staff can agree to a petition, a response may not be available by the return due date.

Because there are not yet any procedural regulations to guide the processing of 25137 petitions the Franchise Tax Board cannot require that petitions be in any particular form or format or that they contain any specified information. However, common sense dictates that a taxpayer wishing to raise a 25137 issue do so in a manner that clearly brings it to the attention of the Franchise Tax Board. To ensure that the issue is dealt with in a timely manner the taxpayer should also provide facts demonstrating that the standard formula does not fairly reflect the business activities of the taxpayer and that it assigns

to California an amount of the taxpayer's income out of all appropriate proportion to the business activities of the taxpayer in the state. If such information is not provided it will have to be secured before the petition can be processed.

3. Franchise Tax Board processes and the role of the three member Franchise Tax Board.

   a. The taxpayer files a petition before, with or after filing a return.

      When the taxpayer files a petition in conjunction with a return seeking approval for the use of an alternative formula there is a danger that the petition will not be recognized for what it is, if it is just submitted along with the return. If a taxpayer wishes to secure approval for a return position the taxpayer should also submit a copy of the petition to the Chief Counsel of the Franchise Tax Board.[19]

      When the petition is identified it will be sent to the Franchise Tax Board Legal Branch for analysis and identification of any additional information needs. If information sufficient to determine whether the use of the standard formula is inappropriate has not been provided, it will be requested, and if an alternative formula has been proposed by the taxpayer, information will be requested to determine whether that formula is reasonable.

      If the taxpayer and the Department reach agreement, the three members of the Franchise Tax Board will be notified and if none of them desire that a hearing be held, the action of the staff will be approved. If the staff and the taxpayer cannot reach agreement the taxpayer will be informed that they have a right to a hearing before the three member Board. If the taxpayer requests a hearing and if the three member board determines to grant a hearing, the taxpayer must waive confidentiality and a hearing on the issue will be scheduled

   b. The application of section 25137 is raised at audit.

      If either the taxpayer or the Franchise Tax Board auditor seek to apply an alternative apportionment formula during the audit process full factual development should occur during the audit and the auditor should make a recommendation on the 25137 issue. If there are statute of limitations issues the audit will be completed and any resulting Notice of Proposed Assessment will be issued and the 25137 issue will be resolved during the protest process. If the statute of limitations does not present a problem,

[19] It is not necessary to submit a copy if the petition simply seeks the application of one of the regulatory variants under Revenue and Taxation Code section 25137, since, when the facts of the taxpayer's situation match the facts of the regulatory variant the regulatory variant is the standard formula.

the 25137 issue will be referred to the Franchise Tax Board Legal Branch for resolution. If the staff and the taxpayer reach agreement the members of the three member Board will be notified, and if none of the members desire a hearing, the action of the staff will be approved. If the staff and the taxpayer cannot reach agreement, the taxpayer will be informed that they have the right to a hearing before the three member Board. If the taxpayer requests a hearing and if the three member Board determines to grant a hearing, the taxpayer must waive confidentiality and a hearing on the issue will be scheduled.[20]

c. The application of section 25137 is raised in a claim for refund.

When a 25137 issue is raised in conjunction with a claim for refund the 25137 element of the claim will be handled in a manner similar to that which applies when the issue is raised in an audit context. The claim will usually be referred to the audit branch for fact gathering and will then be referred to the Legal Branch for analysis and a staff determination. If the staff and the taxpayer reach agreement, the members of the three member Board will be notified, and if none of the members desire a hearing, the action of the staff will be approved. If the staff and the taxpayer cannot reach agreement, the taxpayer will be informed that they have the right to a hearing before the three member Board. If the taxpayer requests a hearing and if the three member Board determines to grant a hearing, the taxpayer must waive confidentiality and a hearing on the issue will be scheduled.

B. The need for procedural regulations.

As the 25137 process becomes more structured and as it is used more often it will probably become necessary to provide greater guidance to taxpayers and to Franchise Tax Board staff. While guidance and direction can be provided to the staff without resort to regulations, any effort to imposed procedural requirements on taxpayers without adopting regulations would run afoul of the Administrative Procedure Act.

For that reason, the department is examining whether regulations to govern and guide the 25137 petition process would benefit taxpayers and the Franchise Tax Board.

Such regulations would probably specify the form and content of a "petition," the time frames within which a petition must be filed, the place within the department to which the petition should be sent, perfection requirements, processing steps and timeframes, the procedure for processing petitions (or staff requests for an alternative formula) based on MATM sections, Legal Rulings and other non-

[20] If it is the staff of the Franchise Tax Board that is seeking to use a special formula, the taxpayer is not required to waive confidentiality and a public hearing is not required.

statutory or non-regulatory authority. Such regulations may also need to cover Franchise Tax Board hearing process and the establishment of a record of decisions that can serve as a guide to action by taxpayers and staff in the future.

1. Implications for Franchise Tax Board staff.

   When the Franchise Tax Board staff seek to invoke section 25137 the regulation could specify the timing and content of the notice that must be provided to the taxpayer. It could further specify whether the staff must demonstrate that the standard formula is distortive before it could apply a special formula set forth in a Legal Ruling or MATM section. The regulation could also specify whether the staff would be permitted to apply a non-statutory or non-regulatory special formula before receiving approval from the three member Board, with the taxpayer having the right to contest the application of the special formula at the level of the three member Board. It could also specify whether the resolution of 25137 issues should follow the resolution of other issues raised in a protest or claim for refund and the obligation of the staff to inform the taxpayer when additional information is needed to resolve a petition and to provide the taxpayer with a specific indication of the information needed.

2. Implications for taxpayers.

   The regulations would specify whether a petition could be filed before or after a return and whether in the absence of an approved petition a return would have to be filed under the standard formula. Any regulation would probably specify the form, format and content of a petition. It would probably require that the petition clearly demonstrate how the standard formula fails to fairly reflect the business of the taxpayer and how it apportions to California a proportion of the taxpayer's income out of all appropriate proportion to the business of the taxpayer in California. The regulation might also require that the petition explain how the alternative formula proposed by the taxpayer is reasonable.

   In imposing time frames on the Franchise Tax Board staff, the regulations would also impose time frames on taxpayers for perfecting petitions and responding to staff requests for additional information. The regulation might also confer upon taxpayers the authority to use one of the non-regulatory or non-statutory special formulas contained in Legal Rulings or the MATM in the filing of a return without the need to secure prior approval.

VII. Miscellaneous cases and issues of interest.

A. *Appeal of Hyundai Motor America*, Cal. St. Bd. of Equal., June 25, 1998, a non-citable decision by the California State Board of Equalization (a start-up marketing operation with no U.S. sales).

A marketing and sales arm of the parent car manufacturer that was unitary with its foreign parent which had losses of $9 million on a separate accounting basis but had income in excess of $1 million for the eight months prior to sales of product in the US when computed on a unitary basis was entitled to section 25137 relief.

Because there were no income producing activities in the US and all income of the unitary group was therefore earned outside the US, the Board of Equalization concluded that separate accounting was appropriate. The circumstance was unique and nonrecurring in part because relief was sought only for the first eight months of operation. The taxpayer's request to use separate accounting in this circumstance was granted.

B. *Union Pacific Corp. v. Idaho Tax Commission* (June 27, 2001) (receipts from the sale of accounts receivable not included in sales factor).

Union Pacific Corporation included accrued freight revenues in the denominator of its sales factor. It also included receipts received from the sale of the accounts receivable that were part of the accruals already included. At issue was whether the money received from the sale of the accounts receivable should be included as sales when calculating the sales factor, thereby increasing the denominator. The court held that including in the apportionment formula set forth in Idaho Code section 63-3027(i) both accounts receivable owing from freight sales and money received from the sale of those accounts receivable resulted in an apportionment formula that did not fairly represent how Union Pacific earned its income.

The Supreme Court remanded the case to the district court to consider an alternative apportionment formula.

C. *Kmart Properties, Inc.* No. 00-04 (NM Dept. of Tax and Rev., January 31, 2001) (sales factor only, apportionment formula).

The threshold issue in *Kmart* involved the successful assertion by the Department of Tax and Revenue of *Geoffrey* [21] nexus as a result of the licensing of intangible assets from KPI, the intangibles holding company, to its affiliate Kmart.

However, the establishment of nexus by itself resulted in little or no income apportioned to New Mexico because there was no (tangible) property, payroll or sales in the state (based on where the costs of performance were incurred). The hearing officer concluded that under the state's UDITPA section18 provision, the Department properly used a single sales factor formula to apportion KPI's income. KPI's only business activity in New Mexico was the licensing of its

[21] *Geoffrey, inc. v. South Carolina Tax Commission*, 313 S. C. 15 (1993).

trademarks for use in New Mexico. Because the income-producing activity, the licensing of KPI's trademarks, could be readily identified, the Department was permitted to include KPI's royalty income from licensing its trademarks in New Mexico in the numerator of the sales factor and its total royalty income in the denominator. The Administrative Law Judge held that the UDITPA three-factor apportionment formula did not fairly represent the activities in New Mexico because, based on KPI's activities in New Mexico, the numerators of both the property and the payroll factors for KPI were zero. Therefore, the alternative single sales factor apportionment formula was held to be reasonable. Oral argument in the Court of Appeal was heard in late July 2001.

D. *Appeal of Key Industries, Inc*., Cal. St. Bd. of Equal., Aug. 10, 2000, a non-citable decision by the California State Board of Equalization (property factor only, apportionment formula).

An Illinois corporation argued that a single factor apportionment formula using only a property factor more accurately represented its activities in California because the business that the corporation carried on in rented warehouse space was its only contact with the state.

However, the Board of Equalization concluded that the standard formula fairly attributed income to California because inventory processing and storage operations at the California warehouse formed a significant segment of one of the corporation's most profitable national business ventures. Moreover, any distortion resulting from using the standard formula, rather than the single property factor formula proposed by the taxpayer, was within the substantial margin of error inherent in any method of attributing income. Thus the taxpayer's request to use a single factor apportionment formula was denied.

E. *Prince Cable Inc*., No. 1309 (Del. App. Bd. 2000) (sales factor only, apportionment formula).

The Delaware Director of Revenue did not abuse his discretion by requiring a cable television company to calculate income using a three-factor formula instead of a single-factor formula. The company's assertion that a single-factor, sales-only formula more accurately reflected income was rejected because application of the three-factor formula resulted in an apportionment percentage that was fair and equitable. Further, the taxpayer's alternative apportionment method of including amounts paid to independent cable installers as part of the total payroll expense for purposes of calculating the payroll factor was also disallowed.

F. *Kennecott Copper Corp. v. State Tax Commission*, 494 P2d 632 (Utah 1972) (destination rule for assigning sales of tangible personal property).

In this extraordinary case, the court sustained the Department of Revenue's decision to ignore the ordinary destination rule for determining the location of sales of tangible personal property for sales factor purposes.

Since Kennecott had property and payroll factors of 33-46 percent for the years in question, but sales (conventionally determined) of less than 1 percent, the court determined that the normal rule "did not fairly reflect the extent of its [Kennecott's] activity in Utah," because the sales factor omitted the sale of products outside Utah. The remedy was to treat the sales of the Utah division as Utah sales, notwithstanding their destination outside the state.

G. *GATX Corp v. Limbach*, 486 NE 2d 840 (Ohio Ct. App. 1984) (elimination of the payroll factor).

To demonstrate that the type of logic used in the *Kennecott Copper*, *supra*, is not limited to rewarding the Tax Commissioner, in this case the taxpayer was successful in convincing the court that because of the difference between the payroll factor percentage on the one hand (approximately 27 percent) and the sales factor percentage and property factor percentages on the other (approximately 1 percent and 3 percent respectively), the payroll factor should be thrown out!

The error in both *Kennecott* and *GATX* is the failure to understand that the point of a three-factor formula is to reflect various aspects of economic activity. Having much more property and payroll than sales (or the reverse, as is often the case in California) merely reflects that certain economic activity is disproportionately present in the state. The mere existence of a disparity between the factors does not, itself, indicate a failure of the overall formula.

The California Board of Equalization certainly got it right in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, when it said:

> "Distortion in one factor … does not necessarily result in unfair reflection of the business activity in the state; the other two factors may well mitigate the distortive effect of the third, so that, ultimately, the taxpayer's business activity in the state is fairly represented through the combination of the three factors in the apportionment formula."

The Board continued:

> "However, it is also possible that one factor may be so distortive that the other two do not mitigate its effect on the formula as a whole. Therefore, whether distortion must be shown in all or just one of the factors will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination."

H. *Chevron USA Inc. v. Mississippi State Tax Commission* (Mississippi Chancery Court) (use of separate accounting).

It was determined that the taxpayer was not permitted, for franchise tax purposes, to use separate accounting rather than apportionment with respect to receipts from "downstream" operations that include refining crude oil to a usable product and the distribution of that product to the consumer.

I. *Pacific Coca-Cola Bottling Co. v. Dept. of Revenue*, 773 P2d 1290 (OR Sup. Ct. 1989) (property factor representation of intangible assets).

Taxpayer, Coca-Cola, challenged the application of the traditional three-factor formula for apportioning combined interstate income for 1967 through 1974. Pacific Coca-Cola Bottling Co. (Pacific) was a wholly owned subsidiary of Coca-Cola, doing business in the states of Oregon and Washington. Although Coca-Cola owned other bottling subsidiaries in addition to Pacific, most of the bottling operations that processed Coca-Cola products worldwide were independently owned franchises. The taxpayer claimed that the statutory formula failed to adequately represent its trademark and advertising activity, as well as its activities involving independently owned bottler franchisees. The taxpayer argued that the Coca Cola Company's huge expenditures for trademark and advertising activity made it unique and distinguishable from other businesses. The taxpayer further argued that property owned and sales made by the independently owned franchisees should be used to develop a substitute apportionment percentage. The court rejected the argument.

It could be argued that, under the facts of this case, Coca-Cola could provide a good argument for section 18 relief on the basis that the standard apportionment formula only takes into account tangible personal property while the major income producing property held by the company consists of its intangible trademarks, trade names and trade secrets, which should be represented in the apportionment formula.